TAB 254

In The Matter Of:

AHERF v.
PRICEWATERHOUSECOOPERS, LLP

DANIEL L. STICKLER
May 9, 2003

LEGALINK MANHATTAN
420 Lexington Avenue - Suite 2108
New York, NY 10170
PH: 212-557-7400 / FAX: 212-692-9171

STICKLER, DANIEL L.

LEGALINK®
A WORDWAVE COMPANY

DANIEL STICKLER

finished or came there afterwards. I don't remember that.

Q. So you are not sure who was the CEO at the time you were performing the management review?

A. I don't recall, no.

Q. Do you recall whether any of the other members of AHERF management who you might have dealt with at other hospitals were similarly cooperative? Or maybe put differently, do you recall any members of AHERF management who were not cooperative in whatever management reviews you performed?

A. No.

Q. Moving down one heading, do you see where it says, in bold letters, "Declining Revenue is the Root of the Problem: The patient volumes are continuing to decline both in terms of inpatient admissions and outpatient surgery. It is this decline that is the root of the continuing financial problems."

A. I see that, yes.

Q. Could you tell me what those lines are about, if you recall?

DANIEL STICKLER

A. I don't remember, I really don't.

Q. Do you recall that there was a declining revenue problem?

A. I wouldn't have written that if I didn't believe that to be the case.

Q. Do you have any recollection about declining revenues at Elkins Park, or in the Delaware Valley in general in this period of time?

A. You have to understand that I've been in I don't even know how many hospitals and medical centers since that time period. To remember which piece happened where is just beyond a possibility, particularly on something like this.

Q. Do you recall any of the market conditions in the Delaware Valley region in 1994?

A. No.

Q. As you may have studied them?

A. No.

Q. Focusing in then on the next set of statements, do you see where it says "As was stated in my earlier report on this hospital, it will not be possible to cure this hospital's

DANIEL STICKLER

problems by cutting expenses. Such expense cuts will temporarily solve the problem; however, the patient revenue declines soon make another round of expense reductions necessary."

A. I see that, yes.

Q. Do you recall having submitted an earlier report on Elkins Park Hospital?

A. I don't recall that, no.

Q. Do you recall anything about your recommendation or statement to Elkins Park management that expense cuts would not solve any of the problems, or the problem of the hospital with respect to declining revenue?

A. I don't recall, no.

Q. I take it, but, as you said with respect to the prior set of statements, that all of the statements in this report you wouldn't have written if you didn't believe it at the time?

A. I would not have written something in the report that I didn't believe at the time.

Q. Do you have any reason to believe that this is not the report that you submitted to AHERF management?

DANIEL STICKLER

A. I don't have any reason to believe that, no.

Q. Turning to page 10 of 24, do you see where there is a signature there of what appears to be to me Daniel L. Stickler? Is that your signature?

A. It appears to be, yes.

Q. Is this handwriting on this page, other than the signature, your handwriting?

A. No.

Q. Do you recognize the handwriting at all?

A. No.

Q. Turning ahead for the moment to page 7 of 24, do you see where at the top it says "Overall expense reductions have been achieved: The overall reductions in man-hours paid, that was implemented in the spring of last year are being sustained."

And then moving down, skipping over some sentences, it says "Based on the overview of the programs as I understand them, I commend the staff for initiating them and cannot make constructive suggestions for improving them."

DANIEL STICKLER

A. I see that, yes.

Q. Do you recall that that was your final recommendation to AHERF management, even if you don't remember the details of the market?

MR. WITTEN: Objection.

A. I was referring specifically to the programs that they had underway to achieve results in those specific areas, and I would not have made that statement if I didn't believe it. But I think you have to be sure you understand that that relates to the entire paragraph and those specific areas at that time.

Q. Which programs are you referring to?

A. The most significant of these are the special surgical supplies and disposable patient supply. I understand from the staff interviews that active programs are underway to bring these areas under control. Based on the overview of programs as I understand them. Those two programs.

Q. Do you recall any of the suggestions you made at the time to AHERF management?

A. No.

Q. Would they have been contained in

DANIEL STICKLER

this report if --

A. They would have been in the report, whatever recommendations I had, yes.

Q. Is there any particular section of this report that contains your suggestions, or are they just interspersed throughout? Feel free to, obviously, look through the report.

A. The question was?

Q. I was just wondering, is there a particular section of this report that contains your suggestions or are they just sort of mentioned throughout, wherever you had them?

A. They appear to be mentioned wherever they occur here in the report.

Q. Before leaving the report, let me just confirm, you have no recollection at all about the market conditions of the Delaware Valley region in 1994?

A. No, none at all.

Q. Do you have any recollection, or did you keep abreast of market conditions in the Delaware Valley region over time prior to arriving at AHERF in 1998?

A. No. Had no reason to.

DANIEL STICKLER

Q. Do you recall, moving away from 1994, what the market conditions were like in the Delaware Valley region in 1998?

A. I don't recall, no.

Q. Did you perform any studies of the market conditions at the time?

A. I did not personally, no.

Q. Did you speak with any members of AHERF management about market conditions at the time?

A. I really don't recall.

Q. Do you recall how you received any information that you can recall about market conditions at the time?

A. I don't recall, no.

Q. Do you at least recall receiving some information about the market conditions at the time?

A. I don't recall, no.

Q. In your practice of doing work in consulting engagements, like the one you performed for AHERF, or The Hunter Group performed for AHERF, is it your normal practice to study the market conditions?

DANIEL STICKLER

A. This was a very untypical engagement in that we came in to perform a performance improvement program, develop a performance improvement program, and that normally, in an institution of that magnitude, would have taken 14 to 16 weeks. Very soon after we got there it became apparent that there was not enough cash to sustain the organization through the development of a turnaround plan and the implementation of a turnaround plan, and so our focus changed completely at that point in time.

Q. Did you have a chance during that time to, if you recall, speak with management about what management was doing at the time to deal with market conditions?

A. I don't recall. My memory of that entire event is not very strong at this point, this many years later, as you're seeing, I guess, from my answers.

Q. Do you recall that in 1997 -- let me take a step back. Do you recall where you were in 1997, what engagement you might have been working on in calendar year 1997 for The Hunter Group?

Page 57

DANIEL STICKLER
A. No. What year did you say this engagement started?
Q. Put differently, do you recall what engagement you might have been working on one year before the AHERF bankruptcy, or before the AHERF bankruptcy?
A. I don't recall specifically, no.
Q. Do you recall that at some point in time the Balanced Budget Act of 1997 was enacted?
A. I recall it was enacted, yes.
Q. And do you recall which hospital system you were working for, what you were working on at the time it was enacted?
A. Not the specific time it was enacted.
Q. Do you recall having any discussions at The Hunter Group about the Balanced Budget Act of 1997?
A. I assume we did, but I don't recall them.
Q. Do you recall any discussions at The Hunter Group about -- or what was your view of the Balanced Budget Act of 1997, from the perspective of someone who manages hospitals?
A. It was going to increase the

Page 58

DANIEL STICKLER
financial problems of the hospitals, because it was going to reduce the cash flow to the hospitals.
Q. And how significant an impact did you expect it would have on hospitals?
A. I don't have an answer to that today. That would be highly dependent on their patient mix, and that type of thing. So it would be different for every hospital.
Q. Could you explain what you mean by it would depend on the patient mix? Do you mean it would depend on what percentage of the patient mix is Medicare patients?
A. Yes.
Q. So hospitals with more Medicare patients as a percentage of the mix of total patients would be more affected by the Balanced Budget Act?
A. They were more dependent on Medicare payments, and when Medicare payments slowed down the rate of increase, and weren't keeping up with inflation, that had a bigger impact on them.
Q. For hospitals with a significant percentage of Medicare patients as a percentage

Page 59

DANIEL STICKLER
of total patients, what was your view at the time as to the impact of the Balanced Budget Act?
A. I couldn't answer that question today.
Q. Do you recall working at any hospitals during your time at The Hunter Group to address the Balanced Budget Act of 1997 and its impact?
A. Not specifically. Most of the engagements I was involved in was in developing the performance improvement program for the hospital or academic medical center that was involved, that in other terms would be thought of as a turnaround plan. So most of the clients that I went into were having some financial difficulty, and we were helping to put together a turnaround plan for them. I'm certain as we did our projections we took into consideration our projected impact of the Balanced Budget Act on that individual hospital, each individual hospital. But I don't recall the numbers from any of them.
Q. And you don't have any sense as to whether the Balanced Budget Act in its impact was

Page 60

DANIEL STICKLER
more significant than any other impacts at the time?
MR. WITTEN: Objection.
A. I couldn't answer that question.
Q. Did you ever come to learn about any cuts that had been made in Pennsylvania, in particular in Philadelphia, for welfare benefits and general assistance benefits that were provided by the state to indigent persons?
A. I can't answer that question. I don't have any recollection of that today.
Q. Did you ever come to learn about the implementation of a mandatory managed care enrollment program for Medicare patients in Philadelphia?
MR. WITTEN: Objection.
A. The question again?
Q. Did you ever come to learn of a mandatory managed care enrollment program for Medicare patients in Philadelphia?
A. I don't recall.
Q. Did you ever learn about or come to learn about the sunsetting of the Certificate of Need requirement in Philadelphia?

DANIEL STICKLER

time, and drove back. There was another guy that I think his residence was in Philadelphia, in the Philadelphia area, who drove in and back.

I'm trying to think who else was there. I don't even remember. Honan's residence was in Florida at the time, I think.

Q. Were there any individuals other than yourself who had had management experience in Pennsylvania in terms of running hospitals, who were on the engagement team?

A. Well, David Hunter, of course. Alan Dzija was on the engagement team and had had experience in the Philadelphia area. I don't remember whether he had -- he worked for one of the consulting firms. I don't know whether he had direct hospital experience or not. I don't recall others.

Q. Was David Hunter actually on the engagement team, or did he just arrange for the engagement to occur and then left it to you?

A. He spent some time there. I couldn't tell you exactly how much. But he spent some time there, and he also spent some time on the phone with me relative to it. But my

DANIEL STICKLER

recollection was he was much more present than any other job I've ever been on.

Q. In terms of what you did under this engagement letter, in terms of just plugging the hole, as you described it, left by Mr. Abdelhak and Dr. Kaye, do you recall what you did when you showed up to work on Monday in terms of your responsibilities at that time?

A. I think we went through all that before. We put together -- we started to put together a performance improvement program. Very early on we shifted and put together this crash program.

Q. So that, what you described earlier was part of this engagement, more or less?

A. It's very hard to separate them. You know, as the interim executive, I start approving, putting out orders, and approving requisitions, and cut expense, and reviewing cost, and reviewing cost reports, and that kind of thing.

MR. TERUYA: I don't think I will spend very much time on these next few exhibits, but I just wanted to show them to you.

DANIEL STICKLER

The next one is number 1555, and it is a one-page document with Bates number HUNT 4493, and it appears to be a supplemental agreement between Kirkpatrick & Lockhart, or a supplement to an agreement between Kirkpatrick & Lockhart and AHERF, dated June 23, 1998.

(Deposition Exhibit 1555 for identification, document Bates stamped HUNT 4493.)

A. Okay. I'm listening.

MR. TERUYA: While you have this exhibit, let me mark another one that you might need to look at simultaneously, as 1556, which has Bates numbers HUNT 4547 through 4549, and it appears to be a fax from William Cullen to Mr. Huoy of The Hunter Group, dated June 25, 1998, and it appears to be forwarding a signature page of an agreement, and an exhibit to an agreement as well, between Kirkpatrick & Lockhart and The Hunter Group.

(Deposition Exhibit 1556 for identification, document Bates stamped HUNT 4547 through HUNT 4549.)

MR. D'ANGEL: Is that it, just two

DANIEL STICKLER

pages behind the cover sheet?

MR. TERUYA: Yes, it is three pages in total, a fax cover sheet, a signature page, and an exhibit page of some sort.

A. Okay.

Q. I was just going to ask you, do you recognize Exhibit 1555?

A. No, I don't.

Q. Do you recognize 1556?

A. No.

Q. Do you have any recollection of an agreement entered into between The Hunter Group and Kirkpatrick & Lockhart?

A. I have a vague recollection that some of our work was contracted with or through Kirkpatrick Lockhart, for whatever reason I don't know or recall.

Q. Do you see on the third page of Exhibit No. 1556 there is a document that says Exhibit 1, and it's from The Hunter Group to Kirkpatrick & Lockhart, dated, at least at the top, June 16, 1998, and it says for assistance in developing a near-term cash management and conservation plan?

Page 153

DANIEL STICKLER

A. Yes.

Q. And then it has a task listing, with a number of tasks, and individuals listed next to it who appear to be Hunter Group members.

A. Yes.

Q. I was just wondering, do you have any understanding of what this page at least is, the Exhibit 1 page?

A. Do I have any understanding of what this page is? I can do interpretation of it, I guess. But do I have a recollection of what it was at the time, no.

Q. Do you have a recollection of -- or looking at this document, does this appear to describe the plan you described, about trying to formulate a turnaround plan of some sort, or the efforts to formulate a turnaround plan?

A. It appears that this describes it a little bit differently than a turnaround plan that I described earlier, and now it's making me wonder about my recollection as to whether the initial engagement of this group of people was, quote, a near-term cash management conservation plan or a full-blown turnaround plan. But this

Page 154

DANIEL STICKLER

list of individuals are the people that were the team that was developing the plan, or working to develop a plan.

Q. So originally David Hunter and yourself were hired to fill the hole left or the void left by Mr. Abdelhak and Dr. Kaye?

A. Yes.

Q. And then this set of individuals, David Hunter, Paul Long, Alan Dzija, Tom Honan, Dean Kinsey, Jeff Gerew and Jack Julius, all came on board to develop some kind of plan, but you are not sure --

A. To develop a plan to try to stop the bleeding.

Q. But you are not sure if it was a full turnaround plan or some kind of near-term cash management and conservation plan?

A. Right. I know that we ended up working on the near-term short one as I told you, the crisis one, instead of the long-term one, and this is the people that came on board to work on that.

Q. But, again, you don't recognize either of these documents or the signatures on

Page 155

DANIEL STICKLER

them?

A. I may have seen them, probably did see them at some point, but I don't have a specific recollection of that.

MR. TERUYA: I am going to mark as Exhibit 1557 a document with Bates numbers HUNT 4500 through 4501, and it appears to be an engagement letter dated July 22, 1998, at the top of it, between The Hunter Group and AHERF, signed by, apparently, Larry Scanlan for The Hunter Group and Anthony Sanzo for AHERF.

(Deposition Exhibit 1557 for identification, document bearing Bates stamps HUNT 4500 and HUNT 4501.)

A. Fire away. I'll try to answer you.

Q. Do you recognize this document?

A. Not specifically, I don't, no.

Q. Does this appear to be the engagement letter between The Hunter Group and AHERF dated July 22, 1998?

A. That's what it appears to be.

Q. Do you recognize David Hunter's signature on the second page of the Exhibit 1557?

A. His signature is not on there. Larry

Page 156

DANIEL STICKLER

Scanlan's is -- oh, yes, David Hunter's is, too, I guess. I don't recognize those signatures, but I wouldn't, you know, necessarily recognize them. I don't have any reason to believe it's not theirs.

Q. Do you have any understanding of what this document is about in terms of the scope of The Hunter Group's engagement by AHERF?

A. Some of the members of the team are the same members that were described in the June engagement letter, and so my -- and my recollection is that this represents an involving role on people's part. And Bill Bricker was added at that point in time as an additional person. Why it was cast in a new engagement letter, I couldn't answer that specifically.

Q. Is this letter --

A. One of the reasons we added Bill Bricker at that point in time was that we were having difficulty meeting the, I won't say needs, I'll say demands of all of the consultants to all the parties, and all the potential purchasers, for information, and running into some -- well, we were having difficulty meeting those demands,

DANIEL STICKLER

and we needed more help to do it, and that's what Bricker was brought in to help do.

Q. When you say all the parties, do you mean consultants to the members of the Creditors Committee, or who are you referring to?

A. Consultants to the members of the Creditors Committee. I don't know, I think there was somebody who was a consultant to the Creditors Committee. I think every health care consultant in the country had some role in this whole thing. And they were struggling for access to information that we were trying to make available primarily to potential purchasers, and at that time it hadn't been narrowed down to two. There were other organizations who were looking at pieces of it. And we were having trouble trying to control the access to the information to people who were supposed to get it, and to get it to those who were supposed to get it.

Q. So in the June 16 engagement letter, at first you and David Hunter were brought on board, you as the interim chief operating officer and him as the interim assistant to the CEO of

DANIEL STICKLER

AHERF, is that right, and also as the engagement director?

A. Interim CEO -- I don't remember the titles. Whatever they are on there. Engagement director -- state the question again, please.

Q. I was just saying, in the June 16, 1998 engagement letter, which I think is Exhibit 1554.

A. Okay.

Q. Do you recall that at that point you and David Hunter were being called in, as you said, to fill certain absences that had been left by departures of AHERF management and that you were going to be the interim chief operating officer and David Hunter was going to be the interim assistant to the CEO of AHERF, who was then Tony Sanzo?

A. Yes.

Q. And then in the June 22, 1998 letter, which is Exhibit 1557, at that point you expanded the team?

MR. WITTEN: Objection.

Q. Is that correct?

A. The team was restructured some, and

DANIEL STICKLER

it was also made clear in that organization that the consulting team would also report to me in my role as interim COO, which is what the chart on the second page was intended to do.

Q. So Dean Kinsey, Bill Bricker, Tom Honan, Alan Dzija and someone else were going to all report to you?

A. Yes.

Q. And was there any reason -- you have already explained why Bill Bricker was brought into the picture. Is there any reason that you added on these other individuals?

A. Those other individuals were on the earlier engagement letter. The team just reassigned some of their responsibilities, but they were already there.

Q. Do you see the first line of Exhibit 1557 says "We are pleased to submit this proposed addendum to the June 16, 1998 interim management agreement"?

A. Yes.

Q. Is this agreement to add on Tom Honan, Alan Dzija, Dean Kinsey and Bill Bricker, and someone else, a supplement to the original

DANIEL STICKLER

letter where just you and David Hunter are named, Exhibit 1555?

A. It's a little difficult for me to figure out right now based on this as to what role the June 23 addendum plays relative to that and what role this other one plays relative to that.

Q. In terms of developing a near-term or some kind of plan in the short run, was there a reason to bring on individuals other than yourself and David Hunter?

MR. WITTEN: Objection.

Q. From your perspective, from The Hunter Group's perspective.

A. Say that question again.

Q. In other words, in connection with developing a plan, whether it be a turnaround plan or a cash conservation plan, was there any reason that you brought on the particular individuals you did to the AHERF engagement?

A. Yes. I mean, we needed help in trying to figure out, put together that 30,000-foot level plan, as to where we thought we could make cuts and how much it would take to

In The Matter Of:

AHERF v.
PRICEWATERHOUSECOOPERS, L.L.P.

DANIEL L. STICKLER
May 28, 2003

LEGALINK MANHATTAN
420 Lexington Avenue - Suite 2108
New York, NY 10170
PH: 212-557-7400 / FAX: 212-692-9171

STICKLER, DANIEL L.

LEGALINK®
A WORDWAVE COMPANY

a duty to understand it even before the audit was done.
Q. But had there been some kind of discrepancy, then that would have triggered for you the need to look into the situation?
A. Absolutely, yes.
Q. Was it your understanding -- I'm not going to ask that.
When you were at AHERF as a consultant to The Hunter Group, did any examples of historic private inurement or potential private inurement come to your attention?
A. If you put into the category of potential private inurement compensation levels to some individuals that I would not have paid myself and would not have considered reasonable, I would say yes. But not being an attorney, I don't know that I'm in a position to pass judgment on those.
Q. Was there any compensation that you can recall right now that really seemed obscene to you?
A. There was a past chairman of cardiovascular surgery, if I remember correctly,

that was still being paid a significant salary sometime after he ceased serving that role, that I would have had some serious concerns about had I been the CEO.
Q. What was that person's name?
A. I knew you were going to ask me that. I can't think of it. That's one example that comes to my mind.
Q. Was that person being paid while you were there?
A. Until we found it and stopped it, yes.
Q. Have you ever heard of the name Carol Talbert?
A. I have, yes.
Q. And in what capacity have you heard of the name Carol Talbert?
A. She was on the corporate staff at one point in time. I don't think she was still there when I got there. She had -- I don't even remember exactly what -- I can't think exactly what her responsibilities were, whether it was physician practice acquisition or management of physician practices. I can't remember what her

responsibilities had been.
Q. Did you ever hear anything about the circumstances of her separation from AHERF?
A. No, I don't recall having heard that. I heard rumors surrounding her name, but those were all very much hearsay and history, and I don't think something that I could quote.
Q. Did you ever hear that she received a $1.6 million settlement to depart AHERF?
A. I don't think I ever heard that, no. I don't think so.
Q. Did you ever hear that she got a consulting contract that paid her $300,000, but that she didn't provide any services in exchange for that contract?
MR. TERUYA: Objection.
A. I don't think so. I assume those things all had happened prior to my arrival there, and, to be honest with you, I wouldn't have paid any attention to them if I had heard them if they were history.
Q. What were the rumors surrounding the name Carol Talbert that you referred to a few minutes ago?

A. Relative to potential personal relationships.
Q. That she was having affairs? Did you hear rumors that she was having an affair with someone else within AHERF?
A. I heard rumors that she had a close personal relationship with someone else within AHERF.
Q. Okay, we will leave it at that. It's already on the record.
Have you ever heard the name Iqbal Paroo?
A. I have, yes.
Q. In what capacity?
A. He was the president of AUHS prior to AHERF acquiring -- he was president of Hahnemann, I guess, prior to AHERF acquiring AUHS, and I think he remained in that role for some time period after they acquired it. I'm not certain.
Q. Did you ever learn or hear anything about the circumstances surrounding of Mr. Paroo's departure from AHERF?
A. No, I did not.
Q. Did you ever hear that he was paid a

DANIEL L. STICKLER

settlement payment for $3 million to release a claim for intentional infliction emotional distress?

A. No, I did not.

Q. Did you ever have any conversations with trustees of AHERF where they indicated that they had known all along that AHERF's financial condition was far worse than the audited financial statements indicated?

MR. TERUYA: Objection.

A. I don't think I did, no.

Q. If you, meaning The Hunter Group, had been on the scene 18 months earlier, say in December of 1996, do you believe that you could have implemented a turnaround plan and avoided bankruptcy?

MR. TERUYA: Objection.

A. Yes, I believe we could have, yes.

Q. And what do you base that belief on?

A. I don't know that I could tie it to specifics, other than my understanding of the organization and the expense reductions that we felt we could make when we put that 30,000-foot plan together. It would have required some

DANIEL L. STICKLER

difficult decisions to be made, but I believe it could have been done.

Q. Is your belief also based in part on your experience in the hospital field?

A. Oh, obviously, yes.

Q. And is your belief based in part on other experience that you have had with other turnarounds?

A. Yes.

Q. And is your belief based in part on what experience that The Hunter Group, not just you, has had in other hospital turnarounds?

A. I guess to some extent.

MR. WITTEN: Let's go off the record for a minute and I will see if I have any more questions.

THE VIDEOGRAPHER: We will go off the record. It is 11:44. And this is tape 5.

(A recess was taken.)

THE VIDEOGRAPHER: Back on the record. It is 11:48, and this is tape 5.

BY MR. WITTEN:

Q. Mr. Stickler, I don't have the Tenet asset purchase agreement here, but I notice

DANIEL L. STICKLER

there's a provision in that asset purchase agreement relating to the fact that some of the monies, some of the purchase price, is going to be used to purchase malpractice insurance tails for the hospitals or the physicians. I don't, frankly, recall which. Do you remember anything about the discussion about the purchase of medical malpractice insurance tails?

A. I recall that the absence of any malpractice coverage was considered by Tenet to be an obstacle to their acquisition, because they were concerned that liability from previous cases may end up accruing to them in the absence of any insurance, and there would not have been any insurance or any way to buy insurance had that not been done.

Q. Was there an absence of insurance covering the AHERF eastern region or some of its assets?

A. My recollection is that there was an offshore insurance company, that there was a question about there being enough assets to cover potential liabilities, and that's one of the reasons why this tail purchase was considered to

DANIEL L. STICKLER

be necessary.

Q. This offshore is a subsidiary of AHERF, the parent?

A. That's my understanding, yes.

Q. Did AHERF go out and purchase its own insurance policies, or did that sub purchase reinsurance?

A. I couldn't answer that question for you.

MR. WITTEN: I don't have any other questions.

MR. TERUYA: I don't know what you folks want to do in terms of scheduling. I probably have about maybe 45 minutes or so to an hour of followup. I don't know if you want to take a quick lunch and come back. It's up to you.

THE WITNESS: Let's do it and get it over.

EXAMINATION BY MR. TERUYA:

Q. Earlier this morning you were talking about your experiences at Cedars Medical Center. Do you recall that?

A. Yes.

Page 379

DANIEL L. STICKLER

Q. That's located down in Florida?

A. Miami, Florida.

Q. And did you previously mention that one of the steps you take -- on day one of your deposition did you mention that one of the steps that you would take in trying to come up with a turnaround plan and to judge its feasibility would be to study the market conditions in which a hospital operates, if you were going to try to turn around a hospital?

A. That would be one of the steps, yes.

Q. And I take it you have never performed any comparison of the market conditions in Florida as they existed while you were in charge of Cedars Medical Center and the market conditions in Philadelphia at the time you were there --

A. We never did a comparison of that, no.

Q. And as you mentioned before, you didn't perform any study of the market conditions in Philadelphia because you didn't have time?

A. That's right. There were reports of a market analysis that had been done by AHERF

Page 380

DANIEL L. STICKLER

that we did review.

Q. But you didn't have a chance to judge whether those were accurate in your view?

A. No.

Q. And you didn't have a chance to use those in formulating a turnaround plan based on them?

A. No. But in most instances, a turnaround plan will -- about market analysis and increased market share -- will in most instances be less than 10 percent of the first three years' turnaround expenses or where you are going to have to do it.

Q. In terms of revenue enhancement or performance improvement in terms of revenue, would that be something, a part of a turnaround plan, that would depend upon an analysis of market conditions, at least in part?

A. Well, as I said, you know, you refer to revenue enhancement. Revenue enhancement involves a much greater piece than just getting more market share. It involves your registration process and your coding process and your billing process, et cetera. And those clearly would

Page 381

DANIEL L. STICKLER

be -- and those can produce more of a short-term effect in a turnaround than the increased market share can.

Q. Would part of what you view as creating a turnaround plan for a hospital include coming up with a business strategy for that hospital going forward?

A. Yes.

Q. And would that include such things as whether to acquire or divest hospitals in the area of a hospital?

A. The long-term business strategy plan would have to include those, yes.

Q. And in formulating a long-term business plan like that, would that involve a study of the market in which a hospital operated, among other things?

A. Yes, as I said previously, it would, yes.

Q. And you never had the chance to perform any kinds of studies like that in Philadelphia because there was no time?

A. We did not. As I indicated, we reviewed the work that had been done. If you

Page 382

DANIEL L. STICKLER

look at the, what was it, list of 87 items, or whatever it was, that was in one of those exhibits, you will notice that there were recommendations to close two hospitals that were part of that, those recommendations. Those were based on current occupancy levels and on the market analysis that had been done by AHERF.

Q. Is your focus in formulating a turnaround plan, at least for the short run, on cost cutting rather than revenue enhancement?

A. Usually about 90 percent of what you can accomplish in a turnaround plan in the first three years is on the cost side, and about 10 percent would be on the revenue side.

Q. And, correspondingly, then, most of the recommendations that you would come up with in formulating a turnaround plan would relate to cost cutting?

A. Yes, sir.

Q. Could you remind me what years you were at Cedars Medical Center?

A. '96 to '91 -- I mean '86 to '91.

Q. Do you recall our discussion on the first day of your deposition about the Balanced

TAB 255

IN THE UNITED STATES DISTRICT COURT FOR THE
WESTERN DISTRICT OF PENNSYLVANIA

- - - -

THE OFFICIAL COMMITTEE OF)
UNSECURED CREDITORS OF)
ALLEGHENY HEALTH, EDUCATION &)
RESEARCH FOUNDATION,)
)
Plaintiff,) Civil Action
) No. 00-684
-vs-)
)
PRICEWATERHOUSECOOPERS, L.L.P.)
)
Defendant.)

- - - -

VIDEOTAPE DEPOSITION OF: JAMES C. STALDER

VOLUME II

- - - -

DATE: March 4, 2004
Thursday, 1:23 p.m.

LOCATION: JONES, DAY, REAVIS & POGUE
500 Grant Street, 31st Floor
Pittsburgh, PA 15219

TAKEN BY: Plaintiff

REPORTED BY: Lissette Sprott
Notary Public
AKF Reference No. LS79722

Page 344

was indeed some confusion, at least in Dionisio's view, at the Kirkpatrick and Lockhart firm about whether or not they were supposed to be preparing an opinion on the endowment issue?
A. I suspect it was in response to having heard from Cathy Hendrickson that she wasn't aware of it, that we said: Joe, you guys have made a representation that this is under way; she doesn't know about it; that concerns us to make sure it's being done.
Q. The next set of notes, sort of the bottom half -- or, roughly, the bottom half of this last page are your comments to Mr. Dionisio?
A. That's correct.
Q. And they follow your initials; is that right?
A. It says: JCS; Will we have an opportunity to plead our case for retention? I'm asking Joe that.
Q. And he responds -- or you have written down that he responded: Maybe; quite possible it will come up; is that right?
A. That's correct.
Q. Can you read the rest of that note after the word Joe?

Page 345

A. Joe, he's saying: Maybe; it's quite possible it will come up. You, Jim Stalder, might be able to explain discussions you have had to date with management with Lee Powar and the reasons for retaining PwC emphasize -- parens, emphasize the PW versus C&L role, close parens. Must set forth the conditions agreed to.
Q. Do you recall what those conditions were?
A. I don't recall. I can only assume it's making reference to the resolution of these issues.
Q. Do you recall anymore about this conversation with Mr. Dionisio today?
A. I do not.

\- - - -

(Exhibit 4360 marked for identification.)

\- - - -

Q. Mr. Stalder, I've just handed you Exhibit 4360. Is this another set of notes in your hand, this time of a conversation on August 24, 1998 with Bill Buettner?
A. It is, and I note you're now backtracking again.
Q. I know, I was about to confess to you that I've got the dates out of order for the first time, I think.

Page 346

A. So it's the same day. I had talked to him earlier, and -- well, I shouldn't say earlier. I can't tell what time this is, but it's the same day I talked to him.
Q. And this, again, is a set of fee estimates; is that right -- or your notes about fee estimates?
A. I'm not going to answer yes to estimates, because I don't -- it might well be the projected fee for the year then under examination, the 1998 fiscal audit, rather than a fee projected, but let's see.
Q. And the only reason I use the word estimate -- well, at least one of the reasons was they seem -- appear to be in round figures.
A. I think he's talking about what was proposed. And when he says in the audit committee book, that would have been the fee proposed of $700,000, which included 25,000 for work done in Caymans, and included the A133, the pension plans and so forth. Why it says six seventy five down from seven hundred, I don't -- can't explain that. And then he said: We progress billed it. And he's giving me pieces, and trying to tell us which were collected and

Page 347

which were not.
Q. Is this information that you thought might be handy to have with you in the upcoming audit committee meeting? Is that why this was assembled, to the best of your recollection?
A. I have no recollection why we're doing that. The only recollection I have about fees was the one that we've talked before, and that was the issue of conflict that presented if we --
Q. Had outstanding fees going into bankruptcy?
A. That's what I particularly --
MR. McDONOUGH: That were not waived.
A. That's right, were not waived. So I don't really know why in this point in time this was coming up.
Q. I take it then you don't recall, really, anything about this conversation, other than what might be reflected in the notes?
A. That's correct.
Q. I'm handing you, Mr. Stalder, a letter from you to Mr. Dionisio dated August 26, 1998 that has been previously marked as Exhibit 4146, and it bears your signature; is that right?
A. That's correct.
Q. And this is a letter you would have sent on

Page 348

that day to Mr. Dionisio?
A. It sure looks that way, yes.
Q. And in it you tell me that you believe PricewaterhouseCoopers is uniquely positioned to assist the company in resolving what were called a set of immediate issues that appear on the next page as expeditiously as possible?
A. That's correct.
Q. And were these issues that were prepared by you or someone else at your direction, the next page and the page that follows? Looks like, really, the issues are only on page two.
A. I can assure you, although I don't recall, this was the work of the team. I wouldn't have created this. This would have been done by the audit people helping with this work.
Q. On the final page, it says -- there's a heading that reads: Why PricewaterhouseCoopers is uniquely positioned to assist; is that right?
A. That's correct.
Q. And the last bullet point there under -- or underneath that heading, reads: If we are approved to continue as your independent accountants for fiscal 1998, we will agree to waive all outstanding receivables from AHERF as

Page 349

of the date of filing; is that right?
A. That's correct.
Q. And that was an offer you recall making?
A. It's here. I mean, I remember -- you asked me whether I remember sending the letter. Yes. Would I remember that particular offer that I made? That wouldn't have been something for me to make. That was the firm concluding that in the process, that was required.
Q. And you don't doubt that you attached the attachment and made the offer; is that fair to say?
A. That's correct.
Q. I'm handing you, Mr. Stalder, what has been previously marked as Exhibit 2105 in this case, which is a set of minutes from a meeting of the finance and audit committee of Allegheny Health Education and Research Foundation held on Thursday, August 27, 1998 at eight a.m., and they're marked draft, and they list you and Mr. Korbly as invitees.
Have I identified the document right?
A. That's correct, you have.
Q. And do you recall attending such a meeting?
A. I do.

Page 350

Q. There are some handwritten notes that appear on the second page of the document and the third page.
Are those notes yours?
A. They are not.
Q. Do you recognize the handwriting?
A. No, I could hardly read it. I'm bad, but not that bad. I do recall that the draft was terribly deficient, and my recollection is this was -- we suggested significant modifications to it; not just the few that I see here.
Q. You recall that the draft of the minutes for this meeting, in your view, were deficient?
A. That's correct.
Q. Did you see drafts before -- well, apparently -- was that your view, or was that the view of someone on the team?
A. Someone on the team -- well, Korbly and I sat there and heard -- sat there and participated in the meeting, and we obviously were the principal in saying: That was not what happened.
Q. Do you recall today what about the draft minutes that you saw, whether they were these or others, was deficient?

Page 351

A. I'd have to study these notes and try to remember, but no, I don't recall, no.
Q. On the final page --
A. Excuse me, I might point out, Jim, that you'll note that Korbly's there, as well as Jim Stalder, in spite of Joe Dionisio's request. Because of the relative roles we were playing, the firm would not permit me to go alone, even though they wanted me to come alone, 'cause I'm not an auditor.
Q. Do you recall that there was indeed, as the minutes here reflect, an executive session from which you and Mr. Korbly were excused? The fact of your being excused is noted at the bottom of page four of the draft minutes, and then it appears that the finance and audit committee went into executive session.
My only question is: Do you recall that there was a continuing portion of the meeting after you left?
A. Yes.
Q. In that continuing portion, I'll just read for you on page six of the minutes, the resolution of the Committee was that it recommend to the board of trustees that the firm

Page 352

PricewaterhouseCoopers LLP be replaced as external auditors for AHERF and subsidiaries.
Do you recall that that was the outcome of the meeting, that recommendation?
A. I do. We were waiting outside in the hall.
Q. And how were you so informed?
A. I believe David Barnes came out and told us that.
- - - -
(Exhibit 4361 marked for identification.)
- - - -
Q. Mr. Stalder, I've handed you now what I think you'll tell me -- or you will tell me are your notes of that 8-27-1998 AHERF audit committee meeting; is that right?
MR. McDONOUGH: 4362?
MR. JONES: 4361, Exhibit 4361.
- - - -
(The witness reviewed the document.)
- - - -
BY MR. JONES:
A. You're right that it looks like that, AHERF audit committee meeting. And then it starts with: Meeting next Thursday. I'm not sure that that makes any sense. Lee in the margin.

Page 353

I'm not sure what this tells me, Jim, to be honest with you. I'd have to really study this in the context of the other notes.
Q. Well, let me just ask this question: They are indeed the notes -- Exhibit 4361 are notes in your hand?
A. They are in my hand, yes.
Q. And they are dated 8-27-98, and headed with the phrase: AHERF audit committee meeting?
A. They are.
Q. Okay. They do refer to what folks you knew to be involved with the AHERF audit committee, like Ira Gumberg and someone named Palmer; is that right?
A. Palmer I recall -- I believe was one of the board members from the Philadelphia end of the --
Q. And he appears to be present at the meeting by video conference?
A. No one -- I don't recall video. I think it was just telephone conference.
Q. All I'm doing is referring to the draft minutes, which reflect a double-asterisked footnote --
A. Then he was.

Page 354

Q. -- to that effect.
A. Not my recollection, but he must have been.
Q. On the next page, the note on the upper right-hand margin, can you read that for me?
A. Obviously, I passed a note to -- this says: Note passed to David Barnes as a reminder during the audit committee meeting. I must have slipped him this note that says: A133 issue, question. I suspect he didn't recall that he didn't raise it, and I was obviously suggesting he should raise it, because they had in jeopardy the grant moneys that Dr. McMaster was worried about.
Q. Mr. Stalder, can you read for me the portion of the minutes that apply to the time period in which you were purportedly in attendance, which I think are on page one, two and three. And then -- with an eye toward what you tell me you can now recall being anything that is deficient about those minutes?
A. Jim, we could try that, but what I'm recalling is an extensively re-drafted set of these things, which we sent back to them and said: There's -- you know, a lot of corrections have to be made. Will I remember them now is

Page 355

dangerous for me to even try.
Q. Well, I don't know that it is, but what I would like is your best recollection. I do have a set of edits to certain minutes, I'm not sure it's this meeting, that I will share with you shortly, I believe. I've seen them, and I don't want to characterize them, but I wouldn't call them extensively re-writing anything.
So if you could just do me the favor, it's really only, essentially, two pages of text, and then let me know if there's anything major that comes to your mind, or substantive, by way of deficiency, I'd like to know it.
MR. McDONOUGH: Well, I object to this exercise, and to the form of a question to read something from five years ago, but if that's how you want to spend your time, go ahead, Mr. Stalder.
MR. JONES: Well, the question is only posed in response to the answer I was given to a prior question.
MR. McDONOUGH: I understand the answer, but it's the follow-up question that doesn't make sense.
- - - -

Page 356

(The witness reviewed the document.)

- - - -

A. I can't even tell what the suggested insert is, for example, on page three, what the -- it says: They are in a general agreement that the financial statements should not be relied upon. I can't even see what that insert is. The whole tone of this was inconsistent with the facts. The whole tone was -- it was Dionisio covering his position. And that's what I know we had -- I had a concern with. The tone was that it was his idea that it had to be restated and so forth and so on. And that's where I know we had -- I had heartburn. What happened with it, I honestly don't recall.
Q. Thank you. And the tone problem for you was that it really wasn't Mr. Dionisio's idea that the 1997 financial statements needed to be restated, but somebody else's?
A. No, no, no. No, the tone -- the key thing that -- from the day I got exercised, was we had been lied to. We, the firm of Coopers & Lybrand had been lied to, and they had covered up the existence of a key document. Joe was choosing -- electing not to disclose that, and

Page 357

I wasn't comfortable with that. I know that fact.
Q. Okay. And the document you referred to, just for clarity, is the Mellon letter we've discussed?
A. That's correct, and the action behind it. You know, not only the existence of it, but the fact that we discovered that there was efforts on the part of AHERF people to prevent that from being seen, and then even after the fact, they were making notes on it. I recall that. They exercised from it. That's the tone that was being lost -- or that reality was being lost, and I felt it was a critically important omission.
Q. Let me ask you this: The first full paragraph on page -- what is page four of the minutes. Are you with me? The four is in the upper right-hand corner.
A. Okay.
Q. Reads -- starts with the words Mr. Dionisio, and it includes a sentence that Mr. Dionisio noted that after extensive consultation with Jim Stalder of PricewaterhouseCoopers --
A. Excuse me, wait a minute, page four?

Page 358

MR. McDONOUGH: It would be page four numbered at the top, so it would be this one.
THE WITNESS: That's page three of the notes.
MR. JONES: I apologize. I --
MR. McDONOUGH: These -- through the various markings, some of these pages wind up with six different page numbers.
THE WITNESS: It's page three of the minutes is what you're --
MR. McDONOUGH: It's CL150835 on the bottom.
MR. JONES: In the lower right-hand corner.
THE WITNESS: I'm there.
BY MR. JONES:
Q. In the sentence in the middle of that first paragraph, which reads: Mr. Dionisio noted that after extensive consultation with Jim Stalder of PricewaterhouseCoopers, they are in general agreement that the financial statements should not be relied upon. It then continues: Mr. Stalder and Mr. Korbly concurred with Mr. Dionisio's report and with the recommendation that users of the financial

Page 359

statements be notified.
Did I read that right?
A. Yes.
Q. And do you agree that that was conveyed by Mr. Dionisio in the meeting?
A. Yes.
Q. Okay. And did you disagree with any of that, those two sentences, when he so conveyed it?
A. What I'm disagreeing with is his careful omission of why.
Q. No, I understand, but you don't disagree with the statement itself; is that fair?
A. No, I do not.
Q. And the why is -- refers to your earlier testimony about the Mellon letter and the background for it?
A. And the related activities of the client, yes. I also recall, now that I look at it, that we had the same kind of concern evolved with the recognition of income from the reserves. He conveniently doesn't disclose that either.
Q. Did you share with Mr. Dionisio what he didn't, in your view, share with the Committee?
A. Yes.
Q. And was this in a subsequent conversation?

TAB 256

Anthony M. Sanzo
President and Chief Executive Officer
Allegheny Health, Education and
Research Foundation

ALLEGHENY
HEALTH, EDUCATION AND
RESEARCH FOUNDATION

320 E. North Avenue
Pittsburgh, PA 15212-4772
412 359-3005
412 359-3888 Fax

TO:	AHERF Executive Staff Hospital Vice Presidents University Leadership Faculty Provost's Staff Medical Staff	
FROM:	Anthony M. Sanzo	III A Martin, Michael P. Sr. Vice President Treasury Operations
SUBJ:	Media Release	
DATE:	September 2, 1998	

The attached media release announcing the possible restatement of our consolidated financial statements will be issued late today and we expect that it will garner significant media attention.

It is important to understand that these matters relate to the entity known as AHERF and certain Eastern Region affiliates.

This latest announcement is in keeping with our stated intent to proactively announce developments within the Allegheny organization and to remain diligent in our examination of our financial situation.

Anthony M. Sanzo

Anthony M. Sanzo

AMS slk

Attachment

DBR-SG
06008

DEPOSITION
EXHIBIT
1289
N.S. 4-30-03

NEWS

ALLEGHENY
HEALTH, EDUCATION AND
RESEARCH FOUNDATION

For Immediate Release
Contact: Thomas G. Chakurda
(412) 359-6896

AHERF CONSIDERS RESTATEMENT OF CONSOLIDATED FINANCIAL STATEMENTS

Pittsburgh, PA – September 2, 1998 – The Finance and Audit Committee of the Board of Trustees of Allegheny Health, Education and Research Foundation (AHERF), together with the new senior management of AHERF and PriceWaterhouseCoopers LLP, are reviewing certain accounting and reporting issues related to the June 30, 1997 consolidated financial statements of AHERF and its affiliates, which they believe may require revision. Accordingly, pending completion of their review, no further reliance should be placed on the financial statements or the Coopers & Lybrand report thereon. Included among the issues being reviewed are:

- a portion of the liability reserves related to the acquisition of the Graduate Hospitals were incorrectly reversed to income, thus, impacting intercompany accounts and net patient revenues; and
- earnings and trading gains from certain restricted funds may have been incorrectly reported as "Net Assets Released From Restrictions" and "Investment Income."

According to the Finance and Audit Committee of AHERF's Board, the latest findings are part of the ongoing process to examine all financial aspects of the Allegheny organization. They reinforced that if further matters surface, they will be addressed on a timely basis.

-30-

DBR-SG
06009

TAB 257

A Review of the Financial Performance of the Allegheny Health Education and Research Foundation 1994 – 1997

November 5, 2004

Prepared by

William O. Cleverley, Ph.D.

President

Cleverley & Associates

Suite 204

438 East Wilson Bridge Road

Worthington OH 43085-2382

888-779-5663

www.cleverleyassociates.com

3. ***Increasing balances of net income attributed to net assets released from restrictions*** With the absence of sufficient underlying unrestricted tangible assets to satisfy creditors in the event of default, increased attention would be devoted to income and cash-flow prospects. We have already observed that AHERF has generated negative values of free-operating cash flow since 1995 (Figure 5). This is a direct result of poor margins from operations.

Reviewing income statements for AHERF from 1994 to 1997 shows increasing amounts of net income being derived from the transfer of restricted net assets:

	Transfers from Restricted Assets to Income (millions)
1994	3.5
1995	5.1
1996	18.9
1997	47.2

Without these transfers, net income and cash flows for AHERF would have been substantially worse. This should cause an analyst to review the sustainability of these transfers in future years.

Table 4 shows changes in temporary restricted net assets for AHERF during 1996 and 1997. Temporary restricted net assets provide the source for most transfers to income. The data in Table 4 show that AHERF's ability to subsidize operations at levels experienced in 1996 and 1997 is very doubtful.

Table 4. Changes in Temporary Restricted Net Assets AHERF (data in millions)

	1996	1997
Beginning temporary restricted net assets	$101.3	$109.0
Adj from change in accounting principles	18.0	---
Contributions	7.0	12.1
Investment income	8.4	22.0
Net assets released	(29.3)	(46.9)
Unrealized appreciation	4.2	(6.0)
Transfer to orther net assets	(0.6)	2.5
Acquisition of affiliates	---	18.0
Change	$7.7	$1.8
Ending temporary restricted net assets	***$109.0***	***$110.8***

Without a one-time revaluation of the portfolio in 1996 ($18.0 million) and the acquisition of an affiliate in 1997 ($18.0 million), the balance in this fund would have shown a sharp decrease. AHERF cannot depend on these events in the future and would likely be forced to reduce transfers. This would have a negative effect on income and cash-flow levels that are already inadequate.

4. ***Increasing balances of operating lease commitments.*** Organizations can also create large balances of future obligations by utilizing operating leases. Operating leases are not capitalized, but their future obligations are shown in footnote disclosure. Table 5 below shows future "Total Minimum Payments" for non-cancelable operating leases, as shown in the AHERF audited financial statements.

Table 5. Non-cancelable Operating Lease Minimum Payment AHERF (000)

	1994	1995	1996	1997
Total minimum payments	$61,761	$78,479	$247,540	$431,676
Long-term debt – net of current position	520,893	608,190	663,971	960,273
Operating lease payment to long-term debt %	11.9%	12.9%	37.3%	45.0%

The data in Table 5 show an alarming increase in obligated payments through operating leases. Credit analysis should have incorporated this factor into the assessment of the financial position of AHERF.

5. ***Unfunded pension liability.*** Footnote disclosure in AHERF's audited financial statements also disclosed a significant decrease in the funded status of its pension plans. In 1994, AHERF had $22.7 million in pension funds in excess of its projected benefits obligations. By 1997, this position had reversed, and AHERF was now underfunded by $22.5 million. This underfunded status would create an additional financial obligation for AHERF.

Conclusion

I believe from my review of the audited financial statements of AHERF and its affiliate DVOG that clear signs of future financial problems were visible in the 1994-to-1997 period. This conclusion is based upon the following points:

1. Neither AHERF nor DVOG experienced levels of profitability that were adequate when compared to any reasonable benchmark of industry performance.

2. Neither AHERF nor DVOG generated positive levels of free-operating cash flow in 1995, 1996, and 1997.

3. Both AHERF and DVOG experienced dramatic declines in liquidity. Values for total days cash on hand were declining throughout the period and were well below expected levels for hospitals rated BBB.

4. Increases in current liabilities in relation to current assets further weakened short-term liquidity positions. Much of the problem started in 1996 with the line of credit increase to $40 million. AHERF and DVOG were starving for cash flow that was not being provided from operations.

5. Levels of debt or financial leverage were extremely high at AHERF and DVOG when compared to any reasonable industry benchmark. These levels were even higher when the large values of restricted net assets and intangible assets were factored into the anlaysis.

6. The sustainability of the past inadequate profit and cash-flow levels was questionable. AHERF was realizing income from inflated levels of transferred restricted net assets that would not likely be sustainable in future years.

The bottom line is simple and obvious. AHERF and its affiliate DVOG were not generating adequate cash flow, they had enormous levels of both short- and long-term debt, and their access to liquid assets had been eroded. I do not understand why any analyst would have concluded this was a reasonably safe investment.

I believe that credit analysts should have perceived from the audited DVOG 1996 statements that a DVOG bankruptcy was a very real possibility within the next several years. DVOG had virtually no available unrestricted cash (20.8 days). It had experienced negative values for free-operating cash flow in both 1995 and 1996. Present levels of short-term and long-term debt were extremely high relative to industry standards. Seventy-two percent of its total assets in 1996 were financed with debt. If restricted funds and non-tangible assets are excluded, the percentage of debt-to-tangible assets increases to 84.4%. In short, DVOG had no cash, no operating cash flow, and enormous levels of debt. While hindsight is perfect, I still believe credit analysts should have seen that DVOG was in a precarious financial position.

TAB 258

UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF PENNSYLVANIA

THE OFFICIAL COMMITTEE)
OF UNSECURED CREDITORS)
OF ALLEGHENY HEALTH, EDUCATION)
AND RESEARCH FOUNDATION,)
)
Plaintiff,)
) Civil Action No. 00-684
v.)
)
PRICEWATERHOUSECOOPERS, LLP,)
)
Defendant.)

EXPERT REPORT OF ROBERT P. MITCHELL, ESQ.

I, Robert P. Mitchell, Esq., am submitting this expert report in the above-captioned case.

I. QUALIFICATIONS

I am a lawyer and partner with Sherman & Howard L.L.C., Denver, Colorado. I received a Bachelor of Arts degree (with honors) from Eastern Montana College in 1970. I received my Juris Doctor degree (with honors) from University of Texas Law School in 1973. I have been admitted to practice in the States of New York (1974) and Colorado (1976).

My practice has concentrated in public finance since 1975, with a particular emphasis on healthcare and public power. I have acted as bond counsel, disclosure counsel, underwriter's counsel, and borrower's counsel in connection with public finance transactions, as well as occasionally as trustee and issuer's counsel.

I have been a member of the National Association of Bond Lawyers since its founding and have served as a panelist on various bond financing matters for the annual Bond Attorneys Workshop. My resume appears at *Tab 1*.

Master Indenture. In my opinion Foley & Lardner was correct in each case. (Mr. Kite ignored the differences in the wording of the two rate covenants in concluding that Foley & Lardner was correct in 1991 and wrong in 1997.) In my opinion, if the 1996 financial reports had shown that DVOG failed to maintain a debt service coverage ratio of 110% (even if such ratio were less than 100%) such a report would not have constituted an incurable Event of Default, and would have been subject to the notice provisions of Section 7.1 and the requirement that a Consultant be retained.

Mr. Kite cites the fact that Foley & Lardner apparently advised AHERF to obtain a waiver from MBIA in connection with the 1994 acquisition of the Hahnemann University Hospital as evidence of an inconsistent opinion. (The Hahnemann Master Trust Indenture rate covenant is worded substantially identical to that in the DVOG Master Indenture.) However, the wording of the September 25, 1994 "Waiver and Direction to Bond Trustee" (Deposition Exhibit 338) does not support Mr. Kite's reading; indeed, it is consistent with the 1997 Foley & Lardner opinion under the identically worded DVOG Master Indenture provisions. The waiver recites that Hahnemann, based on "preliminary interim" financial statements for its June 30, 1994 fiscal year, expects that its Historical Debt Service Coverage Ratio is less that 1.0 to 1.0. In Section 1(a) of the waiver, MBIA waives the requirement of Section 6.3 of the Master Indenture (and an analogous section of the Loan Agreement) that Hahnemann retain a Consultant. In Section 1(b), MBIA directs the Master Trustee "not to deliver a written notice of <u>default</u> pursuant to Section 7.1(a)(ii) of the Master Indenture and will waive <u>any default that may give rise</u> to an Event of Default thereunder as a consequence of the failure to achieve a Historical Debt Service Coverage Ratio of at least 1.0 to 1.0. (Emphasis added)" The wording of the waiver demonstrates clearly that neither MBIA nor Hahnemann is treating the failure to achieve 1.0 to 1.0 historic coverage

as an immediate incurable Event of Default. Instead, it is treated as a circumstance requiring retention of a Consultant and potentially permitting the Master Trustee to give notice, at most a "default that may give rise to an Event of Default." If any of MBIA, Hahnemann, AHERF or Foley & Lardner believed that an incurable Event of Default would exist under the Hahnemann Master Indenture, the wording of the waiver would have reflected that belief. In my experience, sophisticated commercial parties would not proceed in the face of an Event of Default without insisting on a clear and unambiguous waiver of that Event of Default. The wording of the 1994 Hahnemann waiver is consistent, not in conflict, with the 1997 Foley & Lardner opinion construing identical language in the DVOG Master Indenture.

3. *Legal Consequences of DVOG's Failure to Provide Financial Statements prepared in Accordance with GAAP.*

Mr. Kite states that "Sections 1.4 and 6.6 of the DVOG Master Indenture together require that DVOG's financial statements be prepared in accordance with GAAP." However, he quotes no textual support for this assertion. Neither Section 1.4 nor Section 6.6 impose any affirmative covenant to prepare financial statements in accordance with GAAP, in contrast to other AHERF master indentures; nor does the definition of Audited Financial Statements in Section 1.1 of the DVOG Master Indenture. Section 1.4 provides that computations under the Master Indenture are generally to be performed in accordance with GAAP, and allows an election of new GAAP principles. However, the section also makes clear that the "requirements set forth herein [i.e., in the Master Indenture] shall prevail if inconsistent with generally accepted accounting principles." Section 6.6 simply requires the Obligated Group to file its audited financial statements annually with the Master Trustee. Where parties intend to impose an affirmative covenant that an Obligated Group prepare its financial statements in accordance with GAAP, with potential Event of Default consequences, such a covenant is expressly included; the second sentence of Section

5.11(a) of the AGHOG Master Indenture which states "such Audited Financial Statements shall be prepared in accordance with generally accepted accounting principles" is an example of such an express covenant. There is no such express covenant in the DVOG Master Indenture. Thus, even if the DVOG Master Trustee believed DVOG's fiscal year 1996 financial statements were not prepared according to GAAP, in my opinion, that in and of itself would not have permitted the DVOG Master Trustee to declare an "Event of Default" under the DVOG Master Indenture.

4. *Legal Consequences of AGHOG's Failure to Properly Calculate its Consolidated Fund Balance Covenant.*

Mr. Kite notes that as of September 1996, the Morgan Guaranty Reimbursement Agreement contained a covenant that required AGHOG's Consolidated Unrestricted Fund Balances to be at least $200,000,000 at all times. He alleges that "the covenant was breached in fiscal year 1996 because Consolidated Unrestricted Fund Balances had declined to $184.5 million;" and under cross default provisions, "the entire AGHOG financing structure could have collapsed in 1996 had Morgan Guaranty and MBIA been aware of AGHOG's breach of the Consolidated Unrestricted Fund Balance covenant." This analysis ignores two real world considerations. First, the default provision in Section 8 of the Morgan Guaranty Reimbursement Agreement makes clear that Morgan Guaranty's rights only existed if "an Event of Default has occurred and is continuing." Thus, if AGHOG had been made aware of the default, it is my understanding that AHERF in 1996 had the ability to cure the shortfall through transfer of funds which could have repaid the Affiliate loans owed to AGHOG. If so, this would have allowed AGHOG to avoid the default (prior to release of the June 30, 1996 financials) or to cure it after such release and report the default to Morgan Guaranty and the fact that it had been cured. In this case, Morgan Guaranty could not have had the ability to declare an Event of Default, with the cascading cross default consequences, since the default disclosed would not be continuing.

Secondly, the reality of letter of credit backed bond financings is that there are significant costs to a bank's pulling the trigger on an covenant default, since that results in the publicly held bond program collapsing, i.e., being tendered to the bank. In my experience, a letter of credit bank would be loathe to allow such a collapse unless the covenant default is a signal of imminent financial failure of the underlying credit group. Here, I understand, the only problem in AGHOG's case was that its sound financial condition had allowed it to make the loans to affiliates outside the credit group. Particularly given that the shortfall in 1996 was less than 10% of the covenant level, it is not credible to assume that Morgan Guaranty would have risked triggering the collapse of the underlying bond program (since it would have had to fund the purchase of the bonds under its letter of credit) for such a level of non-compliance.

5. *Legal Consequences of AGHOG's Alleged Failure to Prepare Financial Statements in Accordance with GAAP*

Plaintiff's expert alleges a breach of AGHOG's obligation to provide properly audited financial statements under the AGHOG Master Indenture for 1996. As I mentioned above, unlike the DVOG Master Indenture, the AGHOG Master Indenture did contain an affirmative covenant to prepare financial statements in accordance with GAAP. However, under Section 6.01 of the AGHOG Master Indenture, such a covenant breach only becomes an "Event of Default" if the Obligated Group fails to remedy it for 30 days after written notice of the breach is given by the Master Trustee or holders of a requisite percentage of notes. In this case, it seems obvious the Obligated Group would be able to cure the default by issuing revised financial statements in such time frame. In my opinion, if the Master Trustee were provided with revised audited financial statements including an unqualified auditor's opinion within the 30 day cure period, the Master Trustee could not declare an "Event of Default," even if the time period specified in Section 5.11(a) for delivery of such financial statements had expired.

Foley & Lardner also delivered a December 22, 1997 opinion letter (Deposition Exhibit 976) addressed to Coopers & Lybrand as to the consequences of the possible failure of DVOG to comply with the rate covenant for fiscal year 1998 under the DVOG Master Indenture. As discussed above, the Foley opinion noted that the rate covenant does not dictate whether or not any failure by the DVOG to maintain a coverage ratio of not less than 1.0 will result in an "Event of Default" and thus referred to the 30 day notice and cure provision under Section 7.1. As my analysis above makes clear, I agree with the conclusions expressed in this Foley opinion letter. Certainly it is my opinion that Coopers & Lybrand was justified in relying on this opinion letter in releasing its audit letter on the 1997 financial statements of AHERF.

Foley & Lardner advised AHERF in a November 3, 1997 Memorandum (Deposition Exhibit 378) that it interpreted the Centennial Master Indenture (Deposition Exhibit 334) rate covenant similarly, i.e., that retention of a Consultant and undertaking recommended curative actions would preclude the Master Trustee from declaring an Event of Default even if the coverage ratio were below 1.0. (Zimmerman Deposition at 77-78; Brueckel Deposition at 162-63.) The memorandum states specifically that "With AHC having taken such action, thereby precluding the default from becoming an Event of Default, the accountants should be able to release their unqualified audit report." In addition, Mr. Zimmerman acknowledged discussing the approach AHERF was taking to the Centennial rate covenant issue (based on Foley & Lardner's analysis) with Mr. Buettner of Coopers & Lybrand. (Zimmerman Deposition 105-07; 125-27.) In my opinion, Coopers & Lybrand was also justified in relying on this advice in releasing their audit letter on the 1997 financial statements of AHERF.

In addition, Foley & Lardner advised AHERF in January 1998 that its secondary market disclosure report ("SMDR") relating to the fiscal year ending June 30, 1997 need not include

additional disclosure of the matters in the communication from First Union National Bank's attorney to Foley & Lardner (Deposition Exhibits 389 and 390; Zimmerman Deposition 100-102; Brueckel Deposition 200-206.) First Union acted as trustee under the Centennial Master Indenture and related bond issues; in a telephone message its attorney, Mr. Houston, raised three matters: (i) the failure to timely deliver the June 30, 1997 fiscal year financial statements; (ii) whether AHERF constituted an appropriate Consultant and (iii) that one of the 1991 bondholders had asked First Union to give formal notice of default. It was apparently the view of Foley's attorneys that the filing of the audited financial statements and the AHERF report with First Union would preclude it from proceeding with a formal notice of default, and that thus any further disclosure of these matters in the SMDR was not necessary as being material. (Deposition Exhibit 390.) In my experience, these are matters on which corporations and issuers rely on lawyers, rather than accountants, in determining their duties under federal disclosure laws. This is particularly the case where the issues at the heart of the matter involve construing the provisions of the indentures and other financing documents governing what constitutes compliance, a default, an Event of Default, and the rights of trustees. Corporations and issuers turn to their lawyers for guidance in such matters, as AHERF did here.

9. *Would Foley & Lardner's Advice to AHERF Regarding Rate Covenant Compliance have been the same in 1996?*

Regarding the legal consequences of the DVOG failure to meet debt service coverage ratio alleged by Plaintiff in 1996, based on the legal opinion letter Foley & Lardner provided in December 22, 1997, it is my opinion that Foley & Lardner would have advised AHERF management in 1996 that, under both the operative covenants and Section 7.1 of the DVOG Master Indenture, no Event of Default would occur as long as DVOG after notice, retained a Consultant and was diligently pursuing curative actions as prescribed under the DVOG Master

Indenture. Even assuming that Foley & Lardner and AHERF believed that the DVOG 1996 fiscal year financials would demonstrate that historical debt service coverage was less than 110%, based on the wording of the covenant, I can only conclude that they would have advised DVOG to retain a Consultant prior to delivering the 1996 fiscal year financials to the master trustee. Based on their 1997 opinion letter analysis, this would have prevented the master trustee and MBIA from declaring an Event of Default under the DVOG Master Indenture.

10. *Should Foley & Lardner have advised AHERF to disclose Financial Covenant Violations to Coopers & Lybrand prior to release of the 1997 SMDR and Audit?*

From the testimony of the two Foley & Lardner lawyers principally involved in counseling AHERF and it affiliates on debt compliance and disclosure, it appears that they were aware of at least two defaults at the time the 1997 financial statements and annual continuing disclosure statements were being finalized and released. By late January, 1998, Ms. Brueckel became aware that there was a substantial amount due to AGHOG from intercompany loans to DVOG, which were required to be deducted in determining compliance with AGHOG's fund balance covenant under the Morgan Guaranty Reimbursement Agreement. (Brueckel Deposition at 215; Deposition Exhibit 345.) Mr. Zimmerman also was aware of this default. (Zimmerman Deposition at 117.) Yet neither Mr. Zimmerman nor Ms. Brueckel advised AHERF to include notice of such default in the Secondary Market Disclosure Report mailed on February 6, 1998. (Zimmerman Deposition at 118; Brueckel Deposition at 187-88.) Similarly, neither of them advised AHERF to discuss the implications of this default with Cooper & Lybrand prior to releasing the fiscal year 1997 audited financial statements. (Brueckel Deposition at 231; Zimmerman Deposition at 121-122.) This default was a material event requiring disclosure under Securities and Exchange Commission Exchange Act Rule 15c2-12. Foley & Lardner was the primary counsel on whom AHERF was relying for advice on disclosure matters relating to

covenant compliance generally, and in connection with the preparation of the annual Secondary Market Disclosure Report for fiscal year 1997. (Brueckel Deposition at 34-36.) In my opinion, Foley & Lardner should have advised AHERF to include disclosure of this default in the 1997 Secondary Market Disclosure Report which was sent out on February 6, 1998. In addition, in my opinion, Foley & Lardner should have advised AHERF to inform Coopers & Lybrand about this default and its implications for the fiscal year 1997 financial report. An uncured default would have required consideration of whether the amounts outstanding under the Morgan Guaranty Reimbursement Agreement should be treated as current liabilities, as well as footnote discussion.

In addition, it is also clear that by October, 1997 Mr. Zimmerman and Ms. Brueckel were aware that a default had occurred under AHERF's Credit Agreement with Mellon Bank, as a result of DVOG's failure to meet the requirements of its liquidity covenant as of September 30, 1997. (Deposition Exhibit No. 964.) In an opinion letter of April 29, 1998 (Deposition Exhibit No. 970, Mr. Zimmerman characterized the liquidity noncompliance as an immediate Event of Default under Section 7.01(d) of the Mellon Credit Agreement. Although AHERF disclosed an event of noncompliance in connection with such liquidity covenant, Foley & Lardner did not advise AHERF to disclose in the SMDR that an Event of Default had (or might have) occurred. (Zimmerman Deposition at 118.) Such disclosure is required by SEC Rule 15c2-12. In addition, Foley & Lardner did not advise AHERF to discuss the implications of such an Event of Default with Coopers & Lybrand, notwithstanding that they were aware of its implications for treatment of the debt as current. (Zimmerman Depositon at 158-59; Brueckel Deposition at 282-284.) In my opinion, the failure of DVOG to meet the liquidity requirements of the Mellon Credit Agreement was an Event of Default under Section 7.01(d), which should have been disclosed as

TAB 259

IN THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF PENNSYLVANIA

THE OFFICIAL COMMITTEE OF UNSECURED CREDITORS OF ALLEGHENY HEALTH, EDUCATION AND RESEARCH FOUNDATION, Plaintiff, v. PRICEWATERHOUSECOOPERS LLP Defendant.	)	Civil Action No. 00-684 Judge David Stewart Cercone

EXPERT REPORT OF PROFESSOR CHRISTOPHER M. JAMES

November 12, 2004

deteriorating financial situation sooner, steps would have been taken to address the situation."[123] The only PNC witness he cites is Ralph "Mike" Michael, the CEO of PNC's corporate bank. Read in its entirety, Mr. Michael's deposition testimony does not indicate that PNC would have halted AHERF's financial demise. Rather, Mr. Michael testified that there were no established practices or procedures at PNC regarding how to respond to covenant non-compliance in connection with debt obligations.[124] He did not say exactly what PNC would have done, but he indicated that they would have worked with the borrower to improve operations and cash flows.[125] He also states that he does not know what the outcome of any such steps would have been.[126] Thus, the Den Uyl Report does not provide any additional insight into the steps that the Plaintiff's would have taken in the event of a hypothetical covenant violation.[127]

90. The Kite and Den Uyl Reports do not specify what specific actions the banks would have taken in response to the hypothetical covenant violations. They merely speculate that the banks would have taken actions, but do not outline the specific steps the banks would have taken. Given the wide range of potential responses to covenant non-compliance, it is essential to analyze the response of the lenders to actual covenant violations to determine the likely response to a hypothetical covenant violation. It is unlikely that the banks would have taken a course substantially different from what they actually followed when certain covenant violations were detected.

[123] Report of Bruce Den Uyl, p. 21.
[124] Deposition of Ralph S. Michael, p. 151.
[125] Deposition of Ralph S. Michael, p. 166.
[126] Deposition of Ralph S. Michael, p. 168. "Q: And do you know what in fact would have been the outcome of any such steps in this instance with respect to AHERF?" "A: I don't know because again we didn't have the opportunity to do that."
[127] One of the possible steps that Mr. Michael identifies is the introduction of a crisis manager, but he repeatedly says that Tom McCool, the head of PNC's workout group, was in charge of that decision. However, Mr. McCool was asked in his deposition "Q: Do you know personally what steps, if any, any creditor of AHERF or it's affiliates would, in fact, have taken if an event of default had been declared on any of the letters of credit or any other?" Mr. McCool responded, "No." Deposition of Thomas McCool, p. 267-268. He was also asked if he knew what steps, if any, would be taken regarding GAAP violations or material misstatements or if Coopers & Lybrand had issued a qualified opinion. Again, he answered "No." Deposition of Thomas McCool, p. 267. Thus it is pure speculation that a crisis manager would have been brought into the AHERF situation by PNC.

VIII. Bank Actions When Covenants Were Violated

PNC Bank

91. Based on the Berliner Report, the Kite Report asserts that the DVOG debt service coverage covenant would have been breached at fiscal year-end 1996 and 1997.[128] Mr. Kite argues that had this breach been known, PNC would have been in a position to "pursue courses of action to preserve their ability to be repaid and to encourage AHERF, its affiliates and their fiduciaries to pursue strategic business plans to improve the operations of the AHERF system."[129] Mr. Kite further asserts that the actions taken by PNC "could have either avoided bankruptcy or mitigated its effects."[130] Based on my review of PNC's actual response to covenant violations by AHERF and its affiliates, and my experience in the commercial banking industry, it is unlikely that, in response to the covenant violations alleged by the Plaintiff's experts, PNC would have taken a course substantially different from the one actually followed.

92. On December 23, 1997, DVOG informed PNC that it was out of compliance with its liquidity ratio covenant requirement of 2.00 to 1.00 for the 1996 DVOG Letter of Credit. Further, DVOG indicated that it did not anticipate meeting this requirement for the balance of fiscal year 1998.[131] As discussed in Section VII, the occurrence of a covenant violation created a wealth of possible responses from PNC ranging from granting DVOG a waiver to declaring an Event of Default. PNC's inaction in responding to this actual DVOG covenant violation is informative in regards to how PNC may have responded to the Plaintiff's alleged covenant violation at fiscal year-end 1996.

93. Following its receipt of the notice of the covenant violation, PNC had to decide whether to renew the 1993 AGH Letter of Credit that expired in approximately

[128] I have been advised that there is a legal issue regarding whether there would have been an incurable "Event of Default" under the DVOG Master Indenture or First Supplement thereto if DVOG had failed to maintain an annual debt service coverage ratio of 1.00. I understand that Robert P. Mitchell opines in his expert report that there would not have been.
[129] Report of Steven B. Kite, p. 6.
[130] Report of Steven B. Kite, p. 5.
[131] Exhibit 1788.

one month on January 28, 1998. The timing of this renewal provided PNC with considerable leverage to exact concessions from AHERF. In the Credit Information Sheet that was prepared in support of the renewal of the credit, PNC notes the numerous operating and liquidity problems at DVOG. Specifically, DVOG was experiencing considerable losses, its physician practices would potentially take years to turn around and its liquidity was constrained. In short, PNC was aware that DVOG's financial condition and outlook were poor. Despite this negative outlook, the Credit Information Sheet indicated that PNC intended to pursue additional business with AHERF and its affiliates, including treasury management, capital markets and asset management business.[132]

94. PNC was also aware that AHERF had historically transferred funds from its stronger Obligated Groups to support the operations of the weaker ones and to fund AHERF's physician acquisition strategy. As one of AHERF's stronger Obligated Groups, AGHOG had helped fund AHERF's expansion plans. Given the weakness of DVOG and AHERF's historical penchant of transferring funds among its Obligated Groups, PNC should have been aware that the DVOG's weakness could have a direct impact on AGH.

95. Despite the knowledge of DVOG's financial condition and covenant violation, PNC renewed the 1993 AGH Letter of Credit with only one modification to the existing terms: an increase in pricing from 35 basis points to 55 basis points due to a Moody's downgrade of AGH's bond rating.[133] Despite the DVOG covenant violation, the renewed 1993 AGH Letter of Credit contained no additional substantive amendments.

96. Following PNC's decision to renew the 1993 AGH Letter of Credit in January 1998, PNC continued to take limited action with respect to the DVOG covenant violation. On February 26, 1998, more than two months after receiving notice from AHERF, PNC was still uncertain of how to respond. In her quarterly credit summary, the acting PNC RM, Paula Mammarella, indicated that "[s]ignificant

[132] Exhibit 1785.

[133] The renewal included a revised fee of 55 basis points with a provision to increase the fee to 65 basis points or 75 basis points in the event of further declines in AGH's credit rating.

112. Mellon was informed of a DVOG liquidity ratio covenant violation related to the 1997 AHERF Line of Credit in October 1997.[159] The obligated group liquidity ratio covenant in the Credit Agreement mandated that DVOG maintain a liquidity ratio of 1.60 to 1.00. DVOG's reported liquidity ratio was 1.31 to 1.00 as of September 30, 1997 and the group's financial performance was rapidly deteriorating.[160] In an e-mail dated October 28, 1997, Richard Arrington, head of Mellon's Healthcare Banking Group, outlined Mellon's concerns:

> "In summary, [AHERF's] consolidated net loss for the quarter is $42.5mm versus a profit in the prior year period of $3.4mm. We are concerned not only by the level of performance but also by the speed of the deterioration."[161]

Nonetheless, Mellon's Credit Group decided to waive the covenant until the end of calendar year 1997 rather than calling the loan, and did not even further investigate AHERF's liquidity levels by demanding additional financial information or reviewing readily available information.

113. Ultimately, in late-April 1998, at the insistence of certain members of the Mellon Bank Group – specifically TD – AHERF repaid the $89 million that had been borrowed under the 1997 AHERF Line of Credit. This request by the Mellon Bank Group did not benefit the other creditors of the borrower or the borrower itself. Rather, this specific set of creditors benefited at the expense of the other parties. In addition, it is notable that TD, a lender with a limited banking relationship with AHERF pushed aggressively to call the loan, while Mellon, a lender with a broad and profitable relationship with AHERF, was reluctant to call the loan.

[159] Had the liquidity ratio covenant violation been reported at fiscal year-end 1997, Mellon would have likely been notified of the covenant violation in September 1997, one month prior to when Mellon was actually notified.
[160] Exhibit 2346.
[161] Exhibit 2345.

The DVOG Lines of Credit

114. The Kite Report asserts that approximately $57 million in outstanding lines of credit to DVOG entities (the "DVOG Lines of Credit") "would also have been subject to renegotiation" in the event of a breach in the debt service covenant associated with the 1996 DVOG Letter of Credit or in the event that Mellon did not enter into the 1997 AHERF Line of Credit.[162] These outstanding Lines of Credit included $7.5 million between Hahnemann University Hospital and First Union Bank ("First Union Line of Credit"),[163] $33 million across two Lines of Credit between various DVOG entities and PNC ("PNC Line of Credit"), and $16.5 million across two Lines of Credit between Medical College of Pennsylvania and Hahnemann University entities and CoreStates Bank ("CoreStates Line of Credit"). In the event of a covenant violation, small participants without a strong banking relationship with AHERF may have had a desire to exit the credit; however, there is no evidence to indicate that either new or existing lenders would not have replaced them.

115. As discussed earlier, PNC had an extensive banking relationship with AHERF and its affiliates, including its role as the primary credit bank. The credit relationship between PNC and AHERF totaled $144 million in direct exposure as of August 1996 and $140 million as of January 1998. Further, as detailed in this section, PNC's response to actual AHERF covenant violations was typically accommodative. Given PNC's longstanding and profitable relationship with AHERF, as well as its actual response to AHERF covenant violations, I conclude that it is unlikely that PNC would have altered the PNC Line of Credit in the event of a hypothetical DVOG covenant violation at fiscal year-end 1996.

116. CoreStates had a longstanding relationship with both Hahnemann and Medical College of Pennsylvania, and it hoped to leverage its existing Lines of Credit to develop a more substantial relationship with AHERF and its affiliates.[164] In addition, CoreStates had previously extended the Hahnemann Line of Credit

---

[162] Report of Steven B. Kite, p. 18

[163] Formerly First Fidelity Bank.

[164] See, for example, Deposition of Gary Seybold, p. 21-24.

despite the poor fiscal year 1994 financial performance of Hahnemann. When discussing this extension, Gary Seybold, the CoreStates RM at the time, stated "[t]he approval process...is not black and white, and there are a lot of factors that you take into consideration."[165] He also indicated that "...you don't make a decision just off of the financial statements."[166] In addition, the Master Note Agreements governing the CoreStates Line of Credit did not have financial covenants and therefore a hypothetical DVOG covenant violation would not have required action by CoreStates. Furthermore, Mr. Seybold testified that he had never been involved in a credit relationship "where CoreStates demanded repayment of a Line of Credit" nor was he aware of a situation where CoreStates had ever "requested collateral or otherwise restructured a deal" due to a borrower's financial performance.[167] Mr. Seybold's testimony is consistent with my experience in the banking industry that radical actions are rarely taken in situations such as the hypothetical DVOG covenant violation. Finally, CoreStates was one of four banks that bid on the 1997 AHERF Line of Credit. Given my review of responses to covenant violations and my experience in the banking industry, it is unlikely that CoreStates would have taken any radical actions in response to a hypothetical DVOG covenant violation. Further, it is my opinion that if CoreStates decided to exit its Line of Credit, it is likely that another bank would have stepped in and offered a similar Line of Credit in its stead.

117. First Union was one of four banks to bid on the 1997 AHERF Line of Credit. Given my review of responses to covenant violations and my experience in the banking industry, it is unlikely that First Union would have taken any radical actions in response to a hypothetical DVOG covenant violation. Indeed, Thomas Woodward, the First Union Vice President responsible for managing the First Union Line of Credit, testified that he cannot say, "with any degree of certainty" how First Union would have responded in the event of a hypothetical 1996 DVOG covenant violation.[168] Further, it is my opinion that if First Union decided

[165] Deposition of Gary Seybold, p. 55.
[166] Deposition of Gary Seybold, p. 55-56.
[167] Deposition of Gary Seybold, p. 83-84.
[168] Deposition of Thomas C. Woodward, p. 94-96.

to exit its Line of Credit, it is likely that another bank would have stepped in and offered a similar line of credit in its stead.

Morgan Guaranty Trust

118. Based on the Berliner Report, the Kite Report asserts that the AGHOG consolidated unrestricted fund balance covenant contained in the Reimbursement and Security Agreement with MGT was breached both at fiscal year-ends 1996 and 1997.[169] He argues that had this breach been discovered at fiscal year-end 1996, MGT would have been in a position to "pursue courses of action to preserve their ability to be repaid and to encourage AHERF, its affiliates and their fiduciaries to pursue strategic business plans to improve the operations of the AHERF system."[170] He further asserts that the actions taken by MGT, among others, "could have either avoided bankruptcy or mitigated its effects."[171] Based on my review of MGT's response to this covenant violation in early- and mid-1998, and my experience in the commercial banking industry, it is my conclusion that in response to the covenant violations alleged by Plaintiff's experts, it is unlikely that MGT would have taken a course substantially different from what it actually followed.

119. On April 1, 1995, MGT entered into a Reimbursement and Security Agreement with AGHOG in relation to a Letter of Credit backing a $50 million bond issuance. The agreement included, among others, a covenant mandating that AGHOG should maintain a consolidated unrestricted fund balance of at least $200 million at all times. Such a covenant prevented the excessive transfer of funds from AGHOG to elsewhere in the AHERF system, as had occurred in 1993

[169] I understand that Robert P. Mitchell opines in his expert report that, had this covenant breach been discovered, assuming AHERF had cured the breach at or before the time it notified MGT, an "Event of Default" could not have resulted from such breach.

[170] Report of Steven B. Kite, p. 6.

[171] Report of Steven B. Kite, p. 5.

and 1994.[172] MGT wanted to ensure that its obligation would not be "weakened by net outflows to the advantage of other parts of the system."[173]

120. At the end of fiscal year-end 1996, the consolidated unrestricted fund balance was calculated incorrectly: the reported balance was approximately $211 million, while the actual balance was approximately $185 million. MGT had explicitly negotiated this covenant into the agreement, and the calculation was relatively simple to verify, thus it is surprising that MGT did not detect the incorrect calculation.[174] Further, if the covenant had been properly calculated and AGHOG were in violation, it appears that the violation would have been easily cured via an inter-organization transfer from AHERF, as AHERF had more than sufficient liquidity to push the balance above the $200 million threshold.

121. On January 1, 1997, AHERF transferred most of ASRI's operations out of AGHOG, resulting in a $20 million reduction in the consolidated unrestricted fund balance. In response, AHERF requested that MGT reduce the covenant level to $160 million, in exchange for the tightening of two other financial covenants.[175] In May 1997, the parties signed an amendment to the Reimbursement and Security Agreement. The consolidated unrestricted fund balance covenant was reduced to $160 million from $200 million, while the debt service covenant was increased to 1.30 to 1.00 from 1.20 to 1.00 and the debt-to-capitalization ratio was tightened to 63% from 66 2/3%.[176] MGT's willingness to renegotiate these covenants indicates that it was flexible in its management of

---

[172] Exhibit 934.
[173] Exhibit DX-2638.
[174] The AGHOG Balance Sheet at fiscal year-end 1996 specified general net assets of approximately $228 million and receivables from affiliates of $26 million. Once the general net assets were adjusted to account for certain contractual adjustments, the fund balance was $211 million; however, this adjustment failed to subtract the receivables from affiliates of $26 million. Therefore, the actual consolidated unrestricted fund balance at fiscal year-end was approximately $185 million, below the required threshold of $200 million. The materials necessary to make this calculation were received by MGT. Further, since receivables from affiliates had to be subtracted from the general net assets in the calculation of the covenant, it should have been immediately clear to MGT that the covenant was calculated incorrectly. See Exhibits DX-2641 and DX-2642; the Deposition of Susan A. Flanagan, p. 16-18, 130; and the Deposition of Kelly Mertz, p. 296-299.
[175] Exhibit DX-2645.
[176] Exhibit 347.

covenant violations. In this case, MGT traded the loosening of one covenant for the tightening of two others.

122. In January 1998, Foley & Lardner ("F&L"), AHERF's counsel, discovered that AHERF was incorrectly calculating the consolidated unrestricted fund balance covenant related to the 1995 AGHOG Letter of Credit.[177] Upon discovering this issue, F&L failed to prompt AHERF to notify Coopers, failed to cause AHERF to include the corrected calculation in the February 6, 1998 Market Disclosure Report, and failed to promptly disclose the covenant non-compliance to MGT.

123. In March 1998, MGT was finally informed that AGHOG was in violation of the consolidated unrestricted fund balance covenant at fiscal year-end 1997, as well as at September 30, 1997 and December 31, 1997.[178] AGHOG's consolidated unrestricted fund balance as of June 30, 1997 stood at $78 million, significantly out of compliance with the terms of the Amended Reimbursement and Security Agreement related to the 1995 AGHOG Letter of Credit.[179] In a letter to MGT, AHERF outlined the covenant violation and requested that MGT renew the 1995 AGHOG Letter of Credit, which was set to expire on April 13, 1998.[180]

124. The day after receiving the letter indicating that AGHOG was not in compliance with the fund balance covenant, MGT approved a one-year extension of the 1995 AGHOG Letter of Credit.[181] This intention to extend the credit was formalized in a letter dated April 2, 1998. Similar to the extension of the 1993 AGH Letter of Credit granted by PNC, the only significant modification to the terms of the letter of credit was an increase in the fee to 50 basis points from 27.5 basis points. MGT also requested that AGHOG provide it with monthly financial statements beginning with April 1998. This letter also granted AGHOG a waiver of its covenant non-compliance until May 31, 1998.[182]

[177] Exhibit 345.
[178] Exhibit 359.
[179] Exhibit 360.
[180] Exhibit 359.
[181] Exhibit 669.
[182] Exhibit DX-2637.

TAB 260

TREASURY DEPT COPY

OFFICIAL STATEMENT DATED JUNE 13, 1996

NEW ISSUE — BOOK-ENTRY ONLY **Expected Ratings: (See**

In the opinion of Bond Counsel assuming compliance by the Authority and the Members of the Obligated Gro[up] ... interest on the 1996D Bonds is excludable from gross income for purposes of federal income tax ... interest on the 1996D Bonds is not an item of tax preference for either individual or corporate alternative mi[nimum] ... 1996D Bonds may be indirectly subject to corporate alternative minimum tax and certain other taxes imposed on ... described under the caption "TAX EXEMPTION" herein. In the opinion of Bond Counsel under the laws of the Com[monwealth] ... enacted and construed the 1996D Bonds are exempt from personal property taxes in Pennsylvania and the int[erest] ... from Pennsylvania personal income and corporate net income tax. See "TAX EXEMPTION" herein.

$50,000,000
Pennsylvania Higher Educational Facilities Authority
(Commonwealth of Pennsylvania)
Health Services Revenue Bonds
(Allegheny Delaware Valley Obligated Group Project)
Series D of 1996

Dated: Date of Delivery **Due: November 15, 2035**

The tax-exempt bonds of the series described above (collectively the "1996D Bonds") will be issued by the Pennsylvania Higher Educational Facilities Authority (the "Authority") under a Trust Indenture dated as of June 1, 1996 (the "Bond Indenture") between the Authority and Norwest Bank Minnesota, National Association, as trustee, paying agent and bond registrar (in such capacities the "Bond Trustee"). The proceeds from the sale of the 1996D Bonds will be used to finance a pooled loan program (the "Program") and to pay certain costs of issuing the 1996D Bonds. Under the Program, loans will be made from time to time to one or more of The Medical College of Pennsylvania and Hahnemann University, The Medical College of Pennsylvania and Hahnemann University Hospital System, Hahnemann University Hospital, Allegheny United Hospitals, Inc., St. Christopher's Hospital for Children and Hershey Medical Corporation (each hereinafter called an "Initial Participant") and together with their affiliates which may become participants in accordance with the Bond Indenture (the "Participants") pursuant to loan agreements (each a "Loan Agreement") entered into from time to time among the Authority, the Program Administrator (herein defined) and each Participant. Pursuant to the Program, funds will be disbursed to a Participant to finance, refinance or reimburse the costs of capital assets. The 1996D Bonds will be payable from and secured by a pledge of certain funds held by the Bond Trustee under the Bond Indenture and from payments to the Bond Trustee as assignee of the Authority under the Loan Agreements. In addition, the 1996D Bonds will be payable from amounts payable to the Bond Trustee on the Series D Master Note described herein and issued by the Initial Participants, as the initial Members of the Obligated Group under the Master Trust Indenture described herein among the Members of the Obligated Group and Norwest Bank Minnesota, National Association, as trustee (in such capacity the "Master Trustee"). The Series D Master Note constitutes the joint and several obligation of the Members of the Obligated Group under the Master Indenture and is secured thereunder by a pledge and assignment in favor of the Master Trustee of the Gross Revenues of the Obligated Group.

The 1996D Bonds will be issued as fully registered bonds and, when issued, will be registered in the name of and held by Cede & Co., as nominee of The Depository Trust Company ("DTC"), New York, New York. DTC will act as securities depository for the 1996D Bonds. Purchases of the 1996D Bonds will be made only in book-entry form in denominations of $100,000 and integral multiples thereof (except as provided herein) and purchasers will not receive certificates representing their interests in the 1996D Bonds. So long as DTC or its nominee, Cede & Co., is the registered owner of the 1996D Bonds, payments of the principal of, redemption premium, if any, and interest on the 1996D Bonds will be made by the Bond Trustee directly to Cede & Co. Disbursement of such payments to the Direct Participants is the responsibility of DTC and disbursement of such payments to Beneficial Owners of the 1996D Bonds is the responsibility of the Direct Participants and the Indirect Participants. So long as the 1996D Bonds are held by DTC or its nominee in book-entry only form, all references herein to the Registered Owners or Owners of the 1996D Bonds or to the Bondholders shall mean only DTC or its nominee. See "BOOK-ENTRY ONLY SYSTEM" herein.

The 1996D Bonds initially shall be in the Weekly Mode bearing interest at a variable rate per annum determined on a weekly basis as described herein by Merrill Lynch, Pierce, Fenner & Smith Incorporated, as Remarketing Agent. Interest on the 1996D Bonds is payable on the first Business Day of each month commencing July 1, 1996, so long as the 1996D Bonds are in the Weekly Mode.

The 1996D Bonds are required to be purchased on demand (in compliance with the terms stated in each 1996D Bond) of the registered owner thereof upon notice and tender of the 1996D Bonds to the Bond Trustee, as tender agent (in such capacity the "Tender Agent"), from and to the extent of the sources described herein at a price (the "Purchase Price") equal to 100% of the principal amount thereof plus accrued interest as hereinafter described.

Prior to any change from the Weekly Mode to another Interest Mode (as described herein) and under certain other circumstances described herein, the Owners of the 1996D Bonds will be required to tender their 1996D Bonds to the Tender Agent for purchase as described herein.

THE 1996D BONDS ARE SUBJECT TO REDEMPTION PRIOR TO MATURITY AS DESCRIBED HEREIN.

From the date of delivery until June 10, 1999 (unless earlier terminated or extended as described herein), payment of the principal of the 1996D Bonds and up to 49 days' interest on the 1996D Bonds (calculated at the maximum rate of 12%) when and as the same shall be due and payable, and payment of the Purchase Price of 1996D Bonds tendered for purchase as described herein, will be funded by amounts available under an irrevocable letter of credit issued by

PNC Bank, National Association

The 1996D Bonds are limited obligations of the Authority payable only out of the revenues derived by the Authority under the Bond Indenture from the Loan Agreements and the Series D Master Note pledged thereunder and do not constitute a debt or liability of the Commonwealth of Pennsylvania or any political subdivision, agency or instrumentality thereof. Neither the general credit of the Authority nor the credit or taxing power of the Commonwealth of Pennsylvania or any political subdivision, agency or instrumentality thereof is pledged for the payment of the principal of or redemption premium, if any, or interest on the 1996D Bonds. The Authority has no taxing power.

The 1996D Bonds are offered when, as and if issued by the Authority and accepted by the Underwriters, subject to prior sale or withdrawal or modification of the offer without notice, and subject to receipt of the approving legal opinion of Ballard Spahr Andrews & Ingersoll, Philadelphia, Pennsylvania, Bond Counsel. Certain legal matters will be passed upon for the Initial Participants and Members of the Obligated Group by their special counsel, Foley Lardner Weissburg & Aronson, Chicago, Illinois, and by Nancy A. Wynstra, Esquire, Executive Vice President and General Counsel of Allegheny Health, Education and Research Foundation; for the Authority by its counsel, Klett Lieber Rooney & Schorling, a Professional Corporation, Harrisburg/Pittsburgh, Pennsylvania; for the Bank by its counsel Cohen & Grigsby, P.C., Pittsburgh, Pennsylvania and for the Underwriters by their counsel Drinker Biddle & Reath, Philadelphia, Pennsylvania. It is expected that the 1996D Bonds in definitive form will be available for delivery to DTC in New York, New York, on or about June 19, 1996.

This cover page contains certain information for quick reference only. It is not a summary of the issue. Prospective purchasers (including Beneficial Owners) of the 1996D Bonds should read the entire Official Statement to obtain information essential to the making of an informed investment decision.

Merrill Lynch & Co. **Goldman, Sachs & Co.**

PNC Securities

DEPOSITION EXHIBIT 407 AKF

GOV 18633

APPENDIX A

THE OBLIGATED GROUP

The information contained in this Appendix A to the
Official Statement has been obtained from
The Medical College of Pennsylvania and Hahnemann University Hospital System,
Hahnemann University Hospital, Allegheny United Hospitals, Inc.,
St. Christopher's Hospital for Children, Horizon Medical Corporation and
The Medical College of Pennsylvania and Hahnemann University

Summary of Revenue and Expenses

The following table sets forth a summary of revenue and expenses of operations of the Obligated Group for each of the fiscal years ended June 30, 1994 and 1995 and for the ten-month periods ended April 30, 1995 and 1996. Such summary has been prepared on the assumptions that the Obligated Group was constituted on July 1, 1993 and that during the period commencing on such date, the Obligated Group had been in place and had consisted of each of the proposed Members.

The information for the two-year period ended June 30, 1995 has been derived from the combined financial statements of the Obligated Group, audited by Coopers & Lybrand L.L.P., independent public accountants (the "Audited Financial Statements"). The information for the ten-month periods ended April 30, 1995 and 1996 has been derived from the unaudited combined financial statements of the Obligated Group which were prepared in accordance with generally accepted accounting principles applied on a basis consistent with the Audited Financial Statements (except for the change in accounting treatment of support to AIHG) and which reflect all adjustments necessary, in the opinion of management, for a fair presentation of the results of operations for the interim period (the "Unaudited Financial Statements"). The results of operations for the ten months ended April 30, 1996 are not necessarily reflective of the results which may be achieved for the full fiscal year ended June 30, 1996. All of the summary financial information provided below for the two-year period ended June 30, 1995 should be read in conjunction with the Audited Financial Statements and related notes which are included in Appendix B to the Official Statement.

SUMMARY OF REVENUE AND EXPENSES
(Dollars in Thousands)

	Fiscal Year Ended June 30,		Ten Months Ended April 30, (Unaudited)	
	1994	1995	1995	1996
Revenue				
Net patient service revenue	$756,046	$817,407	$661,743	$734,014
Academic activities	56,400	57,605	48,847	52,339
Research and training support	46,511	50,784	34,047	36,242
Other	51,970	57,448	54,906	49,673
Total revenue	910,927	983,244	799,543	872,268
Expenses				
Salaries, wages, and fringe benefits	554,773	550,761	455,211	493,719
Materials, supplies and services	292,971	328,846	261,140	296,580
Depreciation and amortization	45,182	51,324	43,033	44,167
Interest	29,814	28,621	23,889	24,616
Total expenses	922,740	959,552	783,273	859,082
Income (loss) from operations	(11,813)	23,692	16,270	13,186
Nonoperating gains, net	13,444	11,902	8,895	12,832[2]
Excess of revenue and net gains over expenses before restructuring costs and change in accounting principle	1,631	35,594	25,165	26,018
Restructuring costs	38,670[1]	4,645	–	–
Excess (deficiency) of revenue and net gains over expenses before change in accounting principle	(37,039)	30,949	25,165	26,018
Income from change in accounting principle	–	–	–	4,363[2]
Excess (deficiency) of revenue and net gains over expenses	($ 37,039)	$ 30,949	$ 25,165	$ 30,381

(1) Associated primarily with the affiliation of Hahnemann University and AHERF in November 1993 and consist of write-offs of inventory, property and equipment, and good will; management, legal and accounting costs, fringe benefit costs; professional liability costs, and expenses associated with the termination of certain faculty and other employees.

(2) See the subcaption, "General Adoption of SFAS Nos. 117 and 124" above for information relating to a change in accounting principle with respect to the treatment of investment appreciation.

Balance Sheet

The following table sets forth the balance sheet for the Obligated Group as of June 30, 1994 and 1995, which has been derived from the Audited Financial Statements, and as of April 30, 1996, which has been derived from the Unaudited Financial Statements. The balance sheet information as of June 30, 1994 and 1995 should be read in conjunction with the Audited Financial Statements and related notes which are included in Appendix B to the Official Statement.

BALANCE SHEET
(Dollars in thousands)

	June 30,		April 30, (Unaudited)
	1994	1995	1996
Current assets:			
Cash and short-term investments	$ 60,513	$ 30,528	$ 53,807
Receivables:			
Patient accounts, less allowance for doubtful accounts of $25,420 at June, 1994, $36,460 at June, 1995, and $53,840 at April, 1996	118,612	180,340	262,029
Affiliates	11,435	0	0
Other	12,724	22,169	31,239
Inventories	11,080	11,863	12,571
Prepaid expenses	8,478	8,516	4,135
Total current assets	222,842	253,416	363,781
Investments limited or restricted as to use, net of amount to meet current obligations	182,742	174,770	172,429
Property and equipment, net	409,509	397,190	403,593
Other assets	11,870	10,157	15,904
Total assets	826,963	835,533	955,707
Current liabilities:			
Accounts payable	34,258	28,283	39,686
Accrued expenses	78,772	59,297	50,993
Line of credit borrowings	12,800	6,000	56,300
Payables to affiliates	0	4,964	87,953
Deferred revenue	7,683	11,230	18,376
Current portion of self-insurance liabilities	9,477	5,821	4,043
Current portion of long-term debt	6,907	7,083	7,116
Total current liabilities	149,897	122,678	264,467
Long-term debt	345,060	339,452	331,838
Student loans	16,520	17,375	18,501
Payable to affiliates	4,582	22,895	18,862
Self-insurance liabilities	19,451	12,429	11,116
Other noncurrent liabilities	20,522	9,662	9,576
Total liabilities	556,032	524,491	654,360
Net Assets:			
General	191,871	220,204	194,015
Restricted:			
Specific purposes	14,012	16,432	23,978
Endowments	65,048	74,406	83,354
Total net assets	270,931	311,042	301,347
Total liabilities and net assets	$ 826,963	$ 835,533	$ 955,707

GOU 18707

TAB 261

EXHIBIT
1887
8-6-03

MBIA Insured Portfolio Management Department
Hospital Unit Rating & Review Form

To:	File (Filename Pa0543c doc)	Rating Date:	2/28/97
Analyst:	Dick Heberton	Rating:	6B
Obligor:	AHERF Delaware Valley Obligated Group	Policy Numbers:	212700, 212720, 212740
Net Outst. Par:	$262,753,238 as of //	Credit Number:	PA0543
Final Maturity	2021	Pool Parent:	N/A

I. MBIA Rating Assignment, Change or Confirmation

	New Rating	Previous Rating (Date)
Standalone Rating	6B	4B (5/23/96)
LOC Bank Rating (Pool Borrowers)		

LOC Bank Name N/A
FIAD Rating
Expiration of LOC
Renewal of LOC in question? Why?

II. Rating Agency Rating

	New Rating	As of date	Previous Rating
Moody's		5/23/96	Baa
S&P		5/23/96	BBB

III Rating Type

x Surveillance "20/20" Rating (Audits Spread, Analysis Below)
___ Surveillance "SU" Rating (Alert/ACRS Report)
___ Surveillance Review (Audits spread, no write-up)
___ Rating Agency Report Reviewed (Full report only - attach)

IV. Contacts

	Hospital/Obligor	Other
Name of Entity	AHERF	
Contact Name	Mike Martin	
Title	CFO	
Phone No	412-442-2219 (secretary Addie)	
Date of Contact	2/26/97	

Hospital Analysis

The 1.533-bed Allegheny Health. Education and Research Foundation (AHERF) Delaware Valley Obligated Group is a new legal entity formed in 1996. Previously, this credit number had consisted of our exposure to Hahnemann University Hospital. The new Obligated Group consists of Hahnemann and all of its fellow AHERF affiliates in the Philadelphia area The Group members are all controlled affiliates of AHERF and are part of the Allegheny System The Allegheny System is the largest in Pennsylvania with over 2.600 licensed beds and 3,177 students. AHERF is also the parent of the strong 728-bed Allegheny General Hospital in Pittsburgh (PA0325. 2B), Allegheny Integrated Health Group (AIHG, physician practices and ambulatory services) and many others

The Obligated Group members are

- Allegheny University Hospitals
- Allegheny University of the Health Sciences
- St. Christopher's Hospital for Children

Allegheny University Hospitals consists of two Philadelphia tertiary hospitals.

1. Allegheny Center City Hospital - 558 beds (formerly Hahnemann University Hospital) and
2. Allegheny East Falls Hospital - 444 beds (formerly the Medical College of Pennsylvania Hospital),

and two suburban community care hospitals

1. Allegheny Bucks County Hospital - 176 beds and
2. Allegheny Elkins Park Hospital - 175 beds

It also operates an inpatient psychiatric facility (Eastern Pennsylvania Psychiatric Institute) on behalf of the State

Allegheny University of the Health Sciences consists of the former Medical College of Pennsylvania and the academic segment of Hahnemann University Hospital System which were merged on 12/31/94 following the affiliation of Hahnemann with AHERF. Initially it was known as MCP-Hahnemann School of Medicine. It also includes the Schools of Nursing and Public Health

St. Christopher's Hospital for Children is an 180-bed acute care children's hospital and regional referral center in Philadelphia SCHC assumed the assets of a prior Group member. Horizon Medical Corp which owned and managed SCHC's parking garage Horizon withdrew from the Group following its merger with Zurbrugg Hospital.

This Obligated Group was brought together by AHERF to create a strong integrated delivery system in the Philadelphia area in order to gain a competitive advantage in negotiating for managed care contracts The consolidation of the Group has been going on for the past three years and has involved many mergers, restructurings. layoffs and associated write-offs Most the of members were rather lackluster performers prior to their affiliation with AHERF with fairly weak balance sheets

The combined entity shows the scars of those weak balance sheets which were further harmed by $43MM in restructuring write-offs in 1994 and 1995, a large $33MM extraordinary loss due to the refinancing in 1996 and net transfers to other affiliates of $74MM in 1996 and $17MM in the first quarter of fiscal 1997 As a result of these charges, the Group's unrestricted fund balance dropped from $220MM in 1995 to $150MM in 1996 and $134MM as of 9/30/96 With debt of $464MM (including a $58MM line of credit) the Group is woefully undercapitalized. Debt/cap jumped from an already high 61% in 1995 to a staggering 77 5% at 9/30/96.

Cash fell sharply in 1995 from 59 to 33 days due to management's decision to reduce current liabilities. Cash fell further in 1996 to 27 days ($76MM) as A/R days soared to 104 days due to the difficulties of converting the members' A/R systems to the AHERF system. This was anticipated by management and has been partially funded with borrowings under its line of credit The Group also has $123MM of restricted cash This includes $60MM in temporarily restricted endowments, donations and student loans and $63MM in permanently restricted endowments and trusts The AHERF System has about another $200MM in unrestricted cash. mostly at Allegheny General

Good profitability in the last two years appears to partially mitigate this very weak balance sheet, but it depends how you interpret the income statement The spreads show bottom line profits of $1.6MM in 1994, $36MM in 1995, $27MM in 1996 and $9 4MM in the first quarter 1997 But 1994's result excludes a $39MM restructuring charge, 1995's excludes a $4MM restructuring charge and 1996's excludes a $74MM transfer of net assets to affiliates. Of those transfers, $51MM went to support the acquisition (10%) and operation (90%) of physician practices by AIHG Such support of physician practices had previously been accounted for mostly as an expense. For example, in 1995 the Group recorded an expense of $8MM and a net asset transfer of $5MM to AIHG If all of this $51MM had been treated as an expense in 1996, the Group would have recorded a loss of over $24MM instead of a $27MM profit! These transfers continued in the first quarter of 1997 at $17 4MM and, according to CFO Martin, will continue at this pace indefinitely The CFO indicated that they were now accounting for these expenses as transfers because AIHG is a separate corporation and because of the need to not appear to be buying referrals 1996's profit was also boosted by a $8.6MM investment gain relating to the adoption of FAS 124.

AHERF is investing heavily in physician recruitment to help build revenues in the long-run Average acquisition costs are about $150,000 for a primary care practice of 1.5 doctors AHERF initially projected having 500 physicians (90% primary) and one million covered lives under contract by 6/30/98, but they have about 400 physicians now (including Graduate acquisition) and are comfortable staying at that level. The buildup of its primary care network and specialty recruitments are already having an impact as shown by the 8% rise in revenues in 1996 Utilization levels are also rising All hospitals showed an increase in admissions (averaging 5%) Outpatient visits have gone up sharply in the last two years from 339,936 to 661,251 Rising managed care penetration reduced reimbursements which partially offset the benefit of these increases Managed care now accounts for 32.6% of revenues

The tertiary hospitals and St. Christopher's are the money makers in the Group as the medical school generates losses ($5MM in 1996) and the community hospitals have historically posted poor results Losses at the medical schools are projected to decline as AHERF moves to reduce their size and consolidate operations To improve profitability systemwide, AHERF has restructured operations to reduce costs These actions included a reduction of FTEs at each facility.

Applications at the medical schools have fallen sharply from the peak year of 1994 due to the merger of MCP and Hahnemann in January 1995. After rising from 12,200 in 1992 to 19,695 in 1994, applications fell sharply in 1995 to 13,602 and to 12,528 in 1996 Matriculatants also were cut after the merger from 302 in 1994 to 240 in 1995. In 1996, 246 students matriculated. Total enrollment declined from 1,212 in 1994 to 1,121 in 1996 as a result Applications at the Nursing and Public Health schools declined less severely and total enrollment has actually grown since the merger (2,116 in 1996 vs 1,920 in 1994)

The Obligated Group's primary service area consists of most of Philadelphia County, along with a portion of surrounding counties in PA and NJ The Group is the market leader in its service area with a 7 6% share (9% in Philadelphia) This market is very overbedded and is experiencing rapid managed care penetration Recent consolidations have produced strong competitors to the Allegheny System. Competitors include 623-bed Thomas Jefferson (merged with Main Line HS), 703-bed University of Pennsylvania, 445-bed Temple, 524-bed Albert Einstein and the preeminent 301-bed Philadelphia Children's Hospital.

A related, but unaffiliated organization, SDN Inc., is in the process of acquiring Graduate Health System, which has six hospitals in the Philadelphia area SDN has several AHERF executives on its board, but it is not legally part of AHERF. However, Martin indicated that SDN would eventually become part of the Allegheny System, although not part of of the DVOG, at least initially Including the Graduate acquisition, AHERF will have a 15% market share in the Delaware Valley.

Almost all current senior managers in the Group (except at St. Christopher's) have been appointed by AHERF since its affiliation. Recent news articles have reported that AHERF's managers are some of the highest paid in the industry including the CEO, Sherif Abdelhak, who earned $1.2MM in 1995 UC members who met with management describe them as very competent and confident with good turnaround experience

Hospital Legal Structure

Is the Borrower an Obligated Or Restricted Group? YES x NO

List Members: see writeup

Borrower Type

		System Name
Single Hospital		
Two-Three Hospital System	x	Allegheny
Large, Multi-State System		

Type of Exposure (check all that apply)

New Issue		UIT/Secondary		BIG	
Pool (non HBCS)		HBCS Pool		MBIA	x

Support (check all that apply)

Gross receipts or A/R pledge ____
Mortgage ____
Negative Mortgage Pledge ____
Guarantee ____
Name of Guarantor ____
Other Support (Explain) ____

Debt Service Reserve Fund

Funded at inception at MADS ____
Funded at inception at less than MADS ____
Funded due to springing reserve at ____ ____
Not funded - springing reserve at ____ ____
Surety ____
No existing or springing DSRF ____

Is the borrower in compliance with all covenants? YES ____ NO ____

List major covenants and describe any compliance exceptions

Covenant	Section/Doc	Required	Actual	Comments
Rate Covenant	§ /			
Cushion Ratio Covenant	§ /			
Additional Bonds Test	§ /			
Limits on Asset Transfers	§ /			
Other	§ /			

Does the borrower have variable rate debt? YES ____ NO ____
If yes, what is date of Purchase Period expiration? ____
Is the debt backed by a LOC? Which Bank? ____
If MBIA insured, review document summaries and show next date of liquidity facility renewal ____

Other

Is MBIA's exposure related to a crossover refunding? YES ____ NO ____

Comments: